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No. _____

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1989

ERNST & WHINNEY,

Petitioner,

v.

BRADFORD-WHITE CORPORATION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

1. In light of the scienter requirement of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), may an accounting firm be held liable under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, and Exchange Rule 10b-5 promulgated thereunder, solely for failure to disclose its own negligence?

Answered in the affirmative by the court below.

2. Does the Seventh Amendment permit the Court of Appeals to construe a jury's finding that there was no material misstatement or omission in an auditor's opinion that financial statements fairly presented the company's financial condition, to mean that the "fair presentation" was only of the auditor's incomplete knowledge and not of the company's true financial condition?

Answered in the affirmative by the court below.

3. Did the Circuit Court err in ruling as a matter of law that the District Court could not allow a newly announced statute of limitations to be asserted in a trial *de novo*, where the statute of limitations defense had been pleaded but not put in issue at the first trial?

Answered in the negative by the court below.

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OPINIONS BELOW

The District Court's opinion was not reported. The opinion of the Court of Appeals is reported at 872 F.2d 1153 (3d Cir. 1989). The text of the opinion appears in the Appendix at App. 7-26.

JURISDICTION

The decision sought to be reviewed was handed down on April 21, 1989. On May 5, 1989, Ernst & Whinney filed a timely petition for rehearing which was denied on July 14, 1989.

Jurisdiction is proper under 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISIONS AND OTHER LAWS INVOLVED

The constitutional provisions, statutes, and regulations involved in the case are as follows:

15 U.S.C. § 78j:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5:

§240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

U.S. CONST. amend. VII:

In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law.

STATEMENT OF THE CASE

In decreeing liability for mere failure to disclose negligence, the Court of Appeals has made an end run around *Hochfelder's* scienter requirement, has suspended

the operation of the Seventh Amendment by reading the jury's "fair presentation" finding out of the case, and has compounded confusion in the Circuits on the issue of whether the requirement of "loss causation" under Rule 10b-5 can be met where the statement at issue – which did not pertain to the quality of the security or its issuer – did not itself cause the purchaser's loss.

The jury found that the auditor's opinion that the financial statements fairly presented the financial position of the company was accurate. The jurors further found that the auditor did not make a relied-upon, reckless misstatement about even one item of financial information about the company. In the face of these findings, the Court of Appeals has reached out to reverse the District Court's new trial order and mandate a judgment against the auditor for securities fraud. The sole basis for the judgment is the auditor's incorrect statement that the audit was conducted in accordance with generally accepted auditing standards. The court below has thus imposed liability under Rule 10b-5(b) for mere failure to disclose negligence. By circumventing *Hochfelder's* scienter requirement, such liability dramatically expands the scope of the cause of action implied under section 10(b). The Court of Appeals' rationale was that, had the auditor conducted a non-negligent audit, it would have discovered and disclosed material adverse information about the company. But this Court has, in *Hochfelder,* specifically rejected that very theory.

The comprehensive array of the jury's specific finding on all the crucial facets of this case – the elements of

Rule 10b-5, negligence and contributory negligence, and the absence of intent to defraud -- affords this Court a unique opportunity to clarify the scope of federal securities law liability under the Rule, and its relation to state law remedies.

The Complaint

The complaint, filed July 14, 1983, charged that the December 31, 1980 financial statements of W. L. Jackson Manufacturing Co. ("Jackson"), as audited by Ernst & Whinney, misstated Jackson's financial condition, and that Respondent Bradford-White Corp. ("Bradford-White"), relied on those misstatements in buying substantially all of Jackson's outstanding stock from its previous owners.

The complaint was in three counts: Rule 10b-5 securities fraud; common law fraud; and negligent misrepresentation. Jurisdiction was predicated on 15 U.S.C. § 78aa, 28 U.S.C. § 1331, and the principles of pendent jurisdiction.

The Trial Record

Bradford-White and Jackson both manufactured home water heaters. On June 21, 1981, Bradford-White agreed to buy Jackson under a Stock Purchase Agreement. Bradford-White claimed that, in deciding to acquire Jackson, it relied on Jackson's year-end 1980 financial statements as audited by Ernst & Whinney.

Ernst & Whinney had refused to render an unqualified opinion on the financials.[1] Instead, it issued a "going concern" qualification that stated that Jackson had incurred large losses that threatened its survival. In addition, Ernst & Whinney altogether disclaimed an opinion on the company's reserve for product warranty liability. App. 85-86.

The Jury's Findings

After a twelve-day trial in July of 1986, the jury answered special interrogatories. The jurors found that

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[1] An *unqualified opinion*, the most favorable report an auditor may give, represents the auditor's finding that the company's financial statements fairly present the financial position of the company, the results of its operations, and the changes in its financial position for the period under audit, in conformity with consistently applied generally accepted accounting principles. . . . Alternatively, the auditor may give a *qualified opinion*, which states that the financial statements are fairly presented except for, or subject to, a departure from generally accepted accounting principles, . . . or a material uncertainty. . . . [A] *disclaimer of opinion* expresses the auditor's inability to draw a conclusion as to the accuracy of the corporate financial records. . . .

> [A]nything less than an unqualified opinion could send signals to . . . potential investors . . . that the independent auditor has been unable to give the corporation an unqualified bill of financial health.

United States v. Arthur Young & Co., 465 U.S. 805, 818-819 nn. 13-14 (1984). *See also* AICPA Statement on Auditing Standards 58 (April 1988).

the conclusion stated in Ernst & Whinney's opinion contained neither a misstatement nor an omission:

> The financial statements taken as a whole as qualified by the opinion of Ernst & Whinney presented fairly the financial position of the W. L. Jackson Manufacturing Company in accordance with generally accepted accounting principles.

Interrogatory Answer 1(g), App. 28.[2]

The jury also found, however, that Ernst & Whinney by its opinion made misrepresentations or omissions with respect to four line items in the financial statements: inventory, product warranty liability, net worth and net loss. Interrogatory answers 1(a), (c), (d), and (e), App. 27. At the same time the jury found that *not one of these statements* was *both* made with scienter *and* relied upon. Interrogatory answers 2-3, App. 28. Accordingly, not one of them is actionable under Rule 10b-5. Moreover, the jury expressly found that Ernst & Whinney acted *without* "intent to defraud others." Interrogatory answer 5, App. 29.

The jury made yet another finding, however, which the Court of Appeals held to be the "crux" of its imposition of Rule 10b-5 liability: that Ernst & Whinney incorrectly stated that its audit had been conducted in accordance with generally accepted auditing standards

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[2] Generally accepted accounting principles ("GAAP") pertain to the fair presentation of financial information. Generally accepted auditing standards ("GAAS") pertain to the conduct of an audit and reporting thereon.

("GAAS"). Interrogatory answer 1(f), App. 27. This failure to comport with GAAS was the basis for the jury's finding that the audit was negligent. Interrogatory answer 6, App. 29. Moreover, since the auditors as professionals were bound to know the difference between a negligent and a nonnegligent audit,[3] the (erroneous) statement that "our examination was made in accordance with generally accepted auditing standards" was a statement made "without any reasonable ground for believing it to be true" and accordingly was made with "reckless indifference as to whether or not it was true." Interrogatory answers 4 and 2(2), App. 29, 28. The jury further found that the plaintiff relied on the statement that a GAAS audit had been performed. Interrogatory answer 3, App. 28.

Thus the *only* statement by Ernst & Whinney that was (1) a misstatement, (2) made with scienter and (3) relied upon by the plaintiff was the representation that the audit was conducted in accordance with GAAS. Interrogatory answers 1-3, App. 27-28. The factual record thus presents nicely the novel question whether mere failure to disclose negligence suffices to make out a case under Rule 10b-5.[4]

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[3] General Auditing Standard 3 provides: "Due professional care is to be exercised in the performance of the examination and the preparation of the report." American Institute of Certified Public Accountants ("AICPA") Professional Standards AU § 150.02 (June, 1985).

[4] The jury made further findings that entitled Ernst & Whinney to judgment on the common law claims. While the audit had been negligent, Bradford-White's negligence claim was barred by its contributory negligence. Interrogatory

(Continued on following page)

The instructions that were printed among the Interrogatories directed the jury – because it had answered "yes" to interrogatories 1, 2 and 3 – to compute damages, and it did so, in the amount of $1,242,151. Interrogatory answer 10, App. 30. Because the special interrogatories were not accompanied by a general verdict form, *see* Fed. R. Civ. P. 49(a), the damages figure was a finding of fact, not a general verdict.[5] It remained for the Court to mold a verdict. Fed. R. Civ. P. 58(2). On July 30, 1986, the District Court entered judgment for Bradford-White and against Ernst & Whinney for $1,242,151. App. 88.

The New Trial Order

On August 25, 1987, however, the District Court granted Ernst & Whinney's motion for a new trial on the Rule 10b-5 claim, ruling that the jury's finding of fair overall presentation (1(g)) was inconsistent with its finding of material misstatements respecting the line items. 1(a), (c), (d), (e). It noted: "BWC [Bradford-White] all but conceded this contradiction at oral argument." App. 82.

(Continued from previous page)

answers 6 and 8, App. 29-30. Moreover, as noted *supra*, the jury specifically found that Ernst & Whinney, despite its "scienter," *acted without "intent to defraud,"* Interrogatory answer 5, App. 29, barring recovery for common law fraud. The Court of Appeals did not address the trial court's August 25, 1987 judgment in favor of Petitioner on these claims. Only the Rule 10b-5 claim remains before this Court.

[5] *Halprin v. Mora*, 231 F.2d 197, 200-01 (3d Cir. 1956); *McCollum v. Stahl*, 579 F.2d 869, 871-72 (4th Cir. 1978), *cert. denied*, 440 U.S. 912 (1979).

Before the scheduled retrial below, in response to *In re Data Access Sys. Sec. Litig.*, 843 F.2d 1537 (3d Cir.), *cert. denied*, 109 S.Ct. 131 (1988), Ernst & Whinney filed a motion for summary judgment renewing its contention, made in the Answer to the Complaint and in post-trial motions, that the securities fraud claim was time-barred. On September 12, 1988, the District Court granted that motion, App. 32, noting the change in the law of the Third Circuit. Bradford-White appealed.

The Decision of the Court of Appeals

On April 24, 1989, the Court of Appeals reversed. It noted that, with respect to Ernst & Whinney's statement that it had complied with GAAS, Bradford-White had established misstatement, scienter, and reliance. App. 19. It called the finding of undisclosed professional negligence "the crux" of the liability judgment. *Id.*

The court then rejected the District Court's finding of an inconsistency that Bradford-White had "all but conceded" in the District Court. It construed the jury's answer to interrogatory 1(g)[6] to mean simply "that Ernst & Whinney complied with GAAP in the *presentation* of the incomplete data it had obtained as a result of the defective audit." App. 22 (emphasis in original).

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[6] The jurors found: "Ernst & Whinney [did not] ma[k]e a material misrepresentation or a material omission [in opining] that the financial statements taken as a whole as qualified by the opinion of Ernst & Whinney presented fairly the financial position of the W. L. Jackson Manufacturing Company in accordance with generally accepted accounting principles." App. 27.

The Court of Appeals dismissed Ernst & Whinney's contention that the finding of fair overall presentation was inconsistent with a plaintiff's verdict, inferring from the jury's other answers that "Ernst & Whinney's interpretation cannot possibly reflect the jury's intent." App. 20.

The panel then chose to exercise plenary review to hold that the District Court had erred in permitting Ernst & Whinney to assert the statute of limitations defense. App. 24-25.[7]

REASONS FOR GRANTING THE WRIT

THE COURT OF APPEALS HAS EXPANDED LIABILITY UNDER RULE 10b-5 BEYOND THE SCOPE PERMITTED BY *ERNST & ERNST v. HOCHFELDER*, 425 U.S. 185 (1976)

a. The Court of Appeals' judgment allows recovery under Rule 10b-5 for negligence

The Court should grant the writ because the Court of Appeals has "decided a federal question in a way in conflict with applicable decisions of this Court," Sup. Ct. R. 17.1(c), namely, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (hereinafter *Hochfelder*) and *Sante Fe Industries v. Green*, 430 U.S. 462 (1977) (hereinafter *Sante Fe*). In those cases, the Court held respectively that neither negligence

[7] Respondent had not raised this issue, neither party had briefed it, and Respondent had agreed at oral argument before the Court of Appeals that the District Court had acted properly in permitting Ernst & Whinney to raise the defense when it did.

nor breach of fiduciary duty suffices to make out a cause of action under Rule 10b-5. By (1) predicating liability on statements made *without* intent to defraud, and by (2) imposing liability for mere failure to disclose negligence, the Court of Appeals has contravened this Court's precedent.

The jury's many findings frame a number of questions that virtually define Rule 10b-5 liability. The answers given or implied by the court below, if left undisturbed, would vastly expand that liability, and not merely by creating liability for failure to disclose negligence. An auditor's correct opinion that the financial statements as a whole fairly present the condition of the company (Interrogatory answer 1(g), App. 28) has always shielded the auditor from fraud liability. The Court below, however, departs from the "fair presentation" rule. Moreover, the jury found that Petitioner made no knowing or reckless, relied-upon misstatement about the company or its shares. Interrogatory answers 2-3, App. 28. By subjecting the auditor to Rule 10b-5 liability in the absence of such a misstatement, the court below loosens Rule 10b-5's causation requirement. By reviewing this case the Court can, in the definitive context of specific jury findings, declare and clarify important distinctions in the federal law of securities fraud.

1. The Court of Appeals has contravened *Hochfelder* by predicating liability on statements made without intent to defraud

The Court of Appeals noted that the "crux of [its] finding of liability" was the misstatement that the audit

comported with GAAS. App. 19. Recognizing that that statement pertained only to the auditor's due care, and had nothing to do with the value of the securities that Respondent bought, the Court of Appeals linked liability to statements that were more likely to affect the investment decision: " '[H]ad a GAAS audit been conducted,' " the court reasoned, Ernst & Whinney " 'would have uncovered material information as to inventory, product warranty liability, net worth and net income, all of which the jury concluded were materially misstated.' " App. 22-23 (quoting the District Court). Because not one of those line items was itself misstated with scienter and relied upon, however, not one of them is itself actionable under the Rule.

The theory on which the Court of Appeals proceeded was, as will be shown, remarkably reminiscent of the theory this Court rejected in *Hochfelder*. The only difference between the two cases is that, there, the plaintiff based its claim solely on negligence, 425 U.S. at 190 n. 5, whereas here, Respondent bases its claim solely on a failure to *disclose* negligence. Interrogatory answer 1(f), App 27. The Court in *Hochfelder* held that negligence did not suffice. This case thus poses the important question whether a plaintiff can bootstrap negligence into Rule 10b-5 securities fraud merely by pleading failure to disclose it. If mere failure to disclose negligence does suffice, the scope of Rule 10b-5 liability, it seems fair to say, will be dramatically enlarged.

In *Hochfelder*, the plaintiffs alleged the same failure "to conduct[] . . . audits in accordance with generally accepted auditing standards," 425 U.S. at 191, that is the "crux" of the judgment below. App. 19. They charged that

Petitioner "had failed to utilize 'appropriate auditing procedures' in its audits . . . thereby failing to discover internal practices of the firm said to prevent an effective audit. . . ." 425 U.S. at 190. This " 'inexcusable negligence,' " *id.* at n. 5 (citation omitted), enabled the "issuer" to induce plaintiffs to invest in escrow accounts that did not exist. Nevertheless, because the plaintiffs disclaimed " 'deliberate, intentional fraud,' " *id.* (citation omitted), this Court affirmed the District Court's grant of Petitioner's motion for summary judgment, holding that noncompliance with GAAS cannot suffice under Rule 10b-5 even if it leads to misstated numbers – unless plaintiff proves "intent to defraud." 425 U.S. at 193.

The Court of Appeals in this case has embraced precisely the reasoning that this Court disapproved in *Hochfelder.* Noncompliance with GAAS, the court below has held, *is* enough because "had a GAAS audit been conducted, [Ernst & Whinney] would have uncovered material information as to [the line items that] . . . the jury concluded were materially misstated." App. 22-23. That linkage, however, is not permitted under *Hochfelder,* because the jury ruled out intent to defraud generally, Interrogatory answer 5, App. 29, and specifically with respect to any of the line items on which plaintiff relied. Interrogatory answer 2, App. 28.[8] If Ernst & Whinney's statement about professional standards is to serve as a

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[8] The product warranty liability was explicitly disclaimed by Ernst & Whinney, App. 85, and the jury found, was not relied upon by Bradford-White. Interrogatory answer 3, App. 28.

basis for liability here, it must do so without the aid of line items that, although they might have been restated after a GAAS audit, are not themselves actionable under the Rule. *Hochfelder.*[9]

2. Permitting Rule 10b-5 liability for failure to disclose negligence is inconsistent with *Hochfelder*

Unsupported by the line items that were misstated without scienter or reliance, the verdict must stand or fall solely on Ernst & Whinney's failure to disclose professional negligence. On that basis, once more it cannot stand without contradicting *Hochfelder.* If the underlying conduct – failure to meet professional standards – is not actionable under the Rule, then mere failure to disclose that same underlying conduct should not be actionable, either.

Permitting Rule 10b-5 liability for failure to disclose negligence or mismanagement would effectively modify *Hochfelder* (no liability for mere negligence) and *Sante Fe* (no liability for mismanagement or breach of fiduciary duty). A plaintiff who can plead mismanagement or negligence can as easily plead reckless failure to disclose the

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[9] There is a deeper tension between *Hochfelder* and the decision below. With respect to Respondent's common law intentional misrepresentation claim, the jury returned a general, unqualified finding that Ernst & Whinney acted *without* "intent to defraud." Interrogatory answer 5, App. 29. The Court of Appeals' imposition of liability where a jury has ruled out "intent to defraud" contradicts the actual holding of *Hochfelder.* (Respondent itself moved conditionally for a new trial on the ground that the jury's findings with respect to scienter and intent to defraud were inconsistent.)

same conduct. The averment is especially easy where the defendant is a manager or professional who – *as* a manager or professional – "should have known" of his error. Such averments would, as a practical matter, easily convert garden variety mismanagement or professional negligence into a Rule 10b-5 violation.[10]

This relaxed standard for Rule 10b-5 liability would be dangerously easy to satisfy against auditors. Every standard auditor's opinion letter recites: "We conducted our audits in accordance with generally accepted auditing standards." Statement on Auditing Standards 58, April 1988.[11] If the incorrectness of that statement really suffices as a sole predicate for Rule 10b-5 liability, then any auditor who is merely negligent will, notwithstanding *Hochfelder* and *Sante Fe,* be at risk under the Rule, given the requisite purchase or sale of securities. The plaintiff's syllogism would run as follows: (1) an auditor who has performed a negligent audit has no proper basis for the required statement of conformity to GAAS;

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[10] Rule 9(b) of the Federal Rules of Civil Procedure, requiring that fraud be pleaded with particularity, would apparently be satisfied by a plea of negligence, followed by an averment that the conduct complained of was an omission by one who, as a manager or professional, "ought to have known" of his undisclosed negligence.

[11] At the time Ernst & Whinney rendered its opinion in 1981, the required language read, "Our examination was made in accordance with generally accepted auditing standards." AU Section 509.07, in AICPA Professional Standards, Vol. A (1985).

(2) such a statement, made without basis, is necessarily made without regard to whether it is true, and is thus "reckless"; (3) therefore, the auditor is suable under Rule 10b-5 in federal court.

The basic principles that underlie *Hochfelder* and *Sante Fe* counsel against such an expansion of liabilities under an implied cause of action. By imposing liability under the Rule for failure to comply with professional standards, the Court of Appeals has departed from the intent of Congress, which never meant to regulate issues of negligence or common law fiduciary duty under section 10(b). It is the states that have traditionally regulated the conduct of managers and professionals towards their investors and clients. In the absence of a misleading disclosure made with scienter, "it is entirely appropriate . . . to relegate respondent and others in his situation to whatever remedy is created by state law." *Sante Fe*, 430 U.S. at 478 (quotation marks and citations omitted).

Moreover, permitting a federal remedy against auditors for nondisclosure of their own negligence "would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts." *Hochfelder*, 425 U.S. at 214 n. 33. Such an expansion of Rule 10b-5 liabilities would not only burden the federal courts with matters traditionally left to state regulation, but would also invite the "danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5." *Sante Fe*, 430 U.S. at 479 (quotation marks and citations omitted). As this Court has stated elsewhere,

> [t]here has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general. . . . [I]n the field of federal securities laws . . . even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial. . . . [W]e are not the first court to express concern that the inexorable broadening of the class of plaintiff who may sue in this area of the law will ultimately result in more harm than good.

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-40, 747-48 (1975).

If negligence or breach of fiduciary duty is not actionable under the Rule, then failure to disclose the identical misconduct should not be, either. The Court should grant the writ to prevent the evisceration of *Hochfelder* and *Sante Fe*.

3. The Third Circuit has implicitly disagreed with the Fifth Circuit by ruling that Ernst & Whinney's failure to comply with Generally Accepted Auditing Standards proximately caused a Rule 10b-5 loss to Bradford-White

Principles of causation also militate against extending liability to these facts. As noted, Ernst & Whinney's misstatement about its compliance with GAAS had nothing to do with the value of the securities Respondent proposed to buy. Because the financial statements themselves, like those in *Hochfelder*, are not actionable under

Rule 10b-5, Ernst & Whinney's failure to meet professional standards is *damnum absque injuria* under the Rule. Stated differently, Ernst & Whinney's statement about its auditing methods cannot have caused Bradford-White's loss – even if Bradford-White relied on it in entering into the transaction. This absence of "loss causation" requires reversal.

The most systematic treatment of the requirement that the alleged misstatement actually bear some proximate relation to the buyer's loss is the Fifth Circuit's in *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983). There, the court stated:

> The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss. The causation requirement is satisfied in a Rule 10b-5 case *only if the misrepresentation touches upon the reasons for the investment's decline in value.* If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted.

640 F.2d at 549 (emphasis added).[12]

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[12] The *Huddleston* court gave the following illustration:

> [A]n investor might purchase stock in a shipping venture involving a single vessel in reliance on a misrepresentation that the vessel had a certain capacity when in fact it had less capacity than was

(Continued on following page)

Applying that rule to this case, there is no suggestion, nor could there be, that Petitioner's misstatement about its own compliance with professional standards "touch[ed] upon the reasons for the investment's decline in value." *Huddleston*, 640 F.2d at 549. The misstatement had nothing to do with Jackson or its value. It did not overstate an asset or understate a liability. To be sure, Ernst & Whinney did make other statements that did pertain to Jackson. But the jury found that not one of those was made with scienter and relied upon. Ernst & Whinney's statement about its own methods therefore did not proximately cause Bradford-White any injury within the purview of Rule 10b-5.

The Court of Appeals rejected this argument. In doing so, it diverged not only from the Fifth Circuit's ruling in *Huddleston*, but also from the Second and

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(Continued from previous page)

represented in the prospectus. However, the prospectus does disclose truthfully that the vessel will not be insured. One week after the investment the vessel sinks as a result of a casualty and the stock becomes worthless. In such circumstances, a fact-finder might conclude that the misrepresentation was material and relied upon by the investor but that it did not cause the loss.

Id. at 549 n. 25.

Eleventh Circuits, both of which have required proof not only of "but for causation," but of loss causation.[13]

This Court, which has never addressed the issue, (which arises often in suits under subpart (b) of the Rule) should grant the writ to clear up the confusion in the lower courts regarding "loss causation," and to correct the Court of Appeals' expansion of Rule 10b-5 causation to include a new class of plaintiffs who are injured not by an actionable misstatement itself, but by the circumstance of having entered into the transaction.

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[13] *Bennet v. United States Trust Co. of New York*, 770 F.2d 308, 313-14 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986); *Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 61-62 (2d Cir. 1985); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984), *cert. denied*, 469 U.S. 884 (1984) (" 'but for causation is not enough' ") (citation omitted); *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 785 (11th Cir. 1988). *But see Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 710, n. 3 (2d Cir.), *cert. denied sub nom. Wood Walker & Co. v. Marbury Management, Inc.*, 449 U.S. 1011 (1980) (not requiring proof of loss causation in a broker fraud case). *See also Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13, 20-21 (2d Cir. 1986) (comparing loss causation to common law tort concept of proximate causation), *cert. denied sub nom. Arthur Anderson & Co. v. Manufacturers Hanover Trust Co.*, 479 U.S. 1066 (1987); *cf. Bastian v. Petren Resources Corp.*, 681 F. Supp. 530, 534, n. 3 (N.D. Ill. 1988) ("by equating 'loss causation' with 'proximate causation,' the court [in *Manufacturers Hanover*] oversimplified and confused the central issue involved in these cases.").

b. The Court of Appeals has departed from settled precedent by ruling that "fair presentation" is not a complete defense to an accountant's securities fraud liability

Not only is the nondisclosure of negligence (Interrogatory answer 1(f)) an inadequate basis for Rule 10b-5 liability, but fair presentation (Interrogatory answer 1(g)) is a complete defense to such liability. The jury found that Ernst & Whinney opined accurately on the financial statements. The opinion, as qualified, accurately concluded that the financial statements overall fairly presented Jackson in accordance with GAAP. Interrogatory answer 1(g), App. 28. One would suppose that such fair presentation would always be a defense to securities fraud. By ruling that it is not, the Court of Appeals unforseeably extended liability under the Rule. Without evidence that Congress intended such a private cause of action in the first place, the expansion is unwarranted.

The Court of Appeals rejected Ernst & Whinney's invocation of answer 1(g), ruling that the defense "stands in conflict with the jury's other answers which showed that the December 31, 1980, financial statements misrepresented or made material omissions as to inventory and product warranty liability and thus, not surprisingly, net worth and net income or loss. Accordingly, Ernst & Whinney's interpretation cannot possibly reflect the jury's intent." App. 20. With all due respect to the court's mind-reading skills, it cannot dismiss a jury finding on the ground that it cannot have been intended.

Absent a new trial order on inconsistency grounds, the jury's language is binding.[14]

For many years, courts and commentators have agreed that an auditor has not committed a fraud if the

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[14] The jury found that Ernst & Whinney told the truth when it opined that the financial statements, as qualified and overall, fairly presented Jackson's financial condition in accordance with GAAP. Interrogatory answer 1(g), App. 28. The Court of Appeals, however, "construed" that finding to mean "that Ernst & Whinney complied with GAAP in the presentation of the incomplete data it had obtained as a result of the defective audit." App. 22. Contrary to the Court of Appeals' reference to "incomplete data," however, the jury expressly ruled out an "omission." Interrogatory answer 1(g), App. 28. Moreover, the Court of Appeals found fair presentation only "of the incomplete data [Ernst & Whinney] had obtained." But the jury found fair presentation of something else – Jackson's financial condition.

Because the panel's "construction" of the jury's answers cannot be squared with the language of answer 1(g), it violates Ernst & Whinney's rights under the Seventh Amendment. Under that amendment, jury answers may be reconciled only "if it is possible [to do so] under a fair reading of them." *Gallick v. Baltimore & Ohio Railroad Co.*, 372 U.S. 108, 119 (1963).

The injustice of the panel's semantics in "reconciling" the answers is highlighted by the fact that Bradford-White itself "all but conceded" the contradiction between the finding of fair presentation, on the one hand, and the finding that line items were misstated, on the other, at oral argument before the District Court. App. 82. What is more, Bradford-White moved conditionally for a new trial on the ground that the jury's finding of scienter was inconsistent with its finding that there was no intent to defraud. *See supra* at 14 n. 9.

audited financial statements achieve "fair presentation" of the audited concern.[15] The Court of Appeals, in its zeal to reconcile the jury verdict, has done so in a way that departs from this consensus by imposing liability despite fair presentation. Worse, the court provides no guidance as to what standard is to replace fair presentation. Accountants (and investors) should not be deprived of an

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[15] *E.g., United States v. Simon*, 425 F.2d 796, 805-06 (2d Cir. 1969) (affirming jury instruction in criminal securities fraud case "that the 'critical test' was whether the financial statements as a whole *'fairly' presented* the financial position of [the audited company]") (emphasis added), *cert. denied*, 397 U.S. 1006 (1970); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112, 122 (S.D.N.Y. 1974) ("*Fair presentation* is the touchstone for determining the adequacy of disclosure in financial statements") (emphasis added) (citation and quotation marks omitted), *rev'd in part and aff'd in part*, 540 F.2d 27 (2d Cir. 1976). *See also* M.A. Eisenberg, "Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants" (1982) (quoting then-SEC Chairman William Casey to like effect), quoted in 63 Cal. L. Rev. 375, 431 (1975); M. B. Metzger and J. A. Heintz, "Hochfelder's Progeny: Implications for the Auditor," 63 Minn. L. Rev. 36, 113 (1978) ("[l]iability will hinge . . . upon whether the statement 'fairly presents' the financial position of the audited firm. . . .") (emphasis added); T. J. Fiflis, "Current Problems of Accountants' Responsibilities to Third Parties," 28 Vand. L. Rev. 31, 62 (1975) ("fairness is all-important") (emphasis added).

intelligible standard of disclosure, and the Court should grant the writ so the standard can be understood.[16]

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[16] The Court of Appeals also erred when it ruled that the trial judge could not entertain Ernst & Whinney's statute of limitations defense, which was duly pleaded in the answer to the complaint, but not otherwise argued at the first trial. On post-trial motions, Ernst & Whinney renewed the defense, citing precedent that, as the District Court noted, had appeared in the advance sheets a month before trial, and was "a noncontrolling decision." App. 65-66. On this basis the court ruled the defense "waived" as to the first trial, but ordered a new trial on the inconsistency in the jury's answers.

While the matter was still awaiting retrial below, the Court of Appeals overruled three Third Circuit cases and handed down a new statute of limitations. *In re Data Access Sys. Sec. Litig., supra* at 9. Relying on *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971), Ernst & Whinney promptly filed a motion renewing its statute of limitations defense. Because a new trial had been ordered, Ernst & Whinney could assert the defense as of right. *Day v. Amax, Inc.*, 701 F.2d 1258, 1263 (8th Cir. 1983); *United States v. Mischlich*, 310 F. Supp. 669, 672 (D. N.J. 1970) *aff'd sub nom. United States v. Pappas*, 445 F.2d 1194 (3d Cir.), *cert. denied*, 404 U.S. 984 (1971); 66 C.J.S. *New Trial* § 230 at 582 (1950). And even if there had never been a new trial order, and even if Ernst & Whinney had not pleaded the defense in its answer, the District Court could, in its discretion, *still* have permitted reassertion of the defense. *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 401 U.S. 321, 330 (1971); *Emich Motors Corp. v. General Motors Corp.*, 229 F.2d 714 (7th Cir. 1956) (no abuse of discretion in permitting amendment on remand to permit invocation, for the first time in the case, of a newly decided statute of limitations); *Riley v. MEBA Pension Trust*, 452 F. Supp. 117 (S.D.N.Y. 1978), *aff'd*, 586 F.2d 968 (2d Cir. 1978).

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CONCLUSION

For the foregoing reasons, the Court should grant a writ of certiorari to the United States Court of Appeals for the Third Circuit in this matter.

Dated: October 10, 1989 Respectfully submitted,

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(Continued from previous page)

The panel below ignored these legal standards. It summarily declared: "Inasmuch as the claim of waiver raises legal questions, our review on the issue is plenary," App. 24. n. 6, and reversed. This was stark error, made worse by the fact that the Respondent conceded the defense could be asserted. *See supra* at 10 n. 7. The Court should grant the writ to reverse this misapplication of the law and to state the correct rule.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 88-1781 and 88-1828

BRADFORD-WHITE CORPORATION,

Appellant in 88-1781

v.

ERNST & WHINNEY

BRADFORD-WHITE CORPORATION,

v.

ERNST & WHINNEY,

Appellant in 88-1828

D.C. Civil No. 83-3371

SUR PETITION FOR REHEARING

BEFORE: GIBBONS, *Chief Judge*, HIGGINBOTHAM, SLOVITER, BECKER, STAPLETON, MANSMANN, GREENBERG, HUTCHINSON, SCIRICA, COWEN and NYGAARD, *Circuit Judges*

The petition for rehearing filed by Ernst & Whinney in the above captioned matter having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and not judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service

not having voted for rehearing by the court in banc, the petition for rehearing is denied.

BY THE COURT

/s/ Morton I. Greenberg
Circuit Judge

Dated: July 14, 1989

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

DIRECT DIAL-
597-8465

April 21, 1989

TO: (Gardenia L.Brooman, Esq.
(Joseph M. Donley, Esq.
(Patrick W. Kittredge, Esq.

Raymond K. Denworth Jr., Esq., William J. Lehane, Esq. & Horace D.Nalle, Jr. Esq.

T.Maxfield Bahner, Esq.

NOTICE OF JUDGMENT

This Court's opinion was filed and Judgment was entered today in case Nos. 88-1781 & 88-1828 and copies are enclosed herewith.

PETITION FOR REHEARING (FRAP 40)

Your attention is specifically directed to Chapter VIII B of the Court's Internal Operating Procedures.

B. Rehearing In Banc.

Rehearing in banc is not favored and ordinarily will not be ordered except

(1) where consideration by the full court is necessary to secure or maintain uniformity of its decisions, or

(2) where the proceeding involves a question of exceptional importance.

This Court does not ordinarily grant rehearing in banc where the panel's statement of the law is correct and the controverted issue is

solely the application of the law to the circumstances of the case.

Nor, except in rare cases, has the court granted rehearing in banc where the case was decided by a judgment order, a memorandum opinion, or unpublished per curiam opinion.

When a petition for rehearing has been filed by a party as provided by FRAP 35(b) or 40(a), unless the petition for panel rehearing under 40(a) states explicitly it does not request in banc hearing under 35(b), it is presumed that such petition requests both panel rehearing and rehearing in banc.

Filing Time — A petition may be filed within 14 days after entry of judgment. No extension will be granted save for the most compelling reasons. The petition must be *received* in the Clerk's office within the 14 day period.

The petition shall state with particularity the points of law or fact which in the opinion of the petitioner the court has overlooked or misapprehended and shall contain such argument in support of the petition as the petitioner desires to present. No answer to a petition for rehearing will be received unless requested by the court. Oral argument in support of the petition will not be permitted.

Statement of Counsel — Where the party petitioning for rehearing in banc is represented by counsel, the petition shall contain, so far as is pertinent, the following statement of counsel:

> "I express a belief, based on a reason and studied professional judgment, that the panel decision is contrary to decisions of the United States Court of Appeals for the Third Circuit or the

Supreme Court of the United States, and that consideration by the full court is necessary to secure and maintain uniformity of decisions in this Court, to-wit, the panel's decision is contrary to the decision of this Court or the Supreme Court in [citing specifically the case or cases],

Or, that this appeal involves a question of exceptional importance, to-wit [set forth in one sentence]."

Counsel is reminded that sanctions may be imposed for the filling of a frivolous petition for rehearing. *See* Fed. R. App. P. 46(c).

Form — The 15 page limit allowed by the Rule shall be observed.

Number of Copies — An original and 14 copied of a petition for rehearing before the Court in banc is required.

An original and 3 copies of a petition for rehearing before the original panel is required.

Rule 22.1

Attachments — Attached to each petition for rehearing a copy of the judgment, order or decision of the Court as to which rehearing is sought and any memorandum or opinion of the court stating the reasons therefor.

Bill of Costs (FRAP 39)

Filing Time — A party to whom costs are allowed, who desires taxation of costs, shall file a bill of costs within 14 days after judgment. The bill of costs must be *received* in the Clerk's office within the 14 day period.

Form — Counsel desiring to have costs taxed against the unsuccessful party under Rule 39, FRAP is requested to furnish an itemized and verified statement from the printer showing the actual costs per page for reproducing the brief and appendix (if any). Proof of service of the bill of costs must be attached to the bill.

Mandate (FRAP 41)

Issuance Time — The mandate is issued 21 days after judgment. A timely petition for rehearing will stay the issuance. If the petition is denied, the mandate will issue 7 days later. A motion for stay of mandate should be promptly filed if parties intend to file a petition for writ of certiorari to the Supreme Court of the United States.

Sally Mrvos, Clerk

Enclosures

Rev. 5/86

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 88-1781 & 88-1828

BRADFORD-WHITE CORPORATION,

Appellant in 88-1781

v.

ERNST & WHINNEY

BRADFORD-WHITE CORPORATION,

v.

ERNST & WHINNEY,

Appellant in 88-1828

On Appeal from the United States
District Court for the
Eastern District of Pennsylvania
(District Court No. 83-3371)

Argued March 14, 1989
BEFORE: MANSMANN, GREENBERG, and
SCIRICA, *Circuit Judges*
(Filed April 21, 1989)

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OPINION OF THE COURT

GREENBERG, *Circuit Judge.*

This is a securities law case under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5, in which Bradford-White Corporation, the buyer of the stock of W.L. Jackson Manufacturing Co., is suing Ernst & Whinney, the accounting firm that prepared the financial statements for Jackson on which Bradford-White relied in purchasing the stock. Following a jury trial on the federal securities law claim and pendent Tennessee state law claims for common law fraud, malpractice and negligent misrepresentation, the district court sent the case to the jury on a set of special interrogatories. The court then molded a verdict in accordance with the jury's answers and entered judgment in favor of Bradford-White for $1,242,151 on July 25, 1986. The judgment does not indicate whether the recovery was predicated on a federal or state cause of action, or both.

In post-trial motions to amend the judgment or for a judgment notwithstanding the verdict, or, in the alternative, for a new trial, Ernst & Whinney contended that the jury's answers to the special interrogatories were irreconcilable. It also urged, relying on the decision in *Friedlander v. Troutman, Sanders, Lockerman & Ashmore*, 788 F.2d 1500 (11th Cir. 1986), decided May 9, 1986, that the securities law claim was barred by the statute of limitations. The court agreed that the answers were irreconcilable and, by order of August 25, 1987, amended the judgment on the state law claims for no cause of action in favor of Ernst & Whinney. Further, the court vacated the judgment on the federal securities law claim and ordered a new trial limited to that claim. However, it denied Ernst & Whinney's motion to amend the judgment on the securities law claim or to grant it a judgment notwithstanding the verdict in its favor on that claim.

The court in its opinion of August 25, 1987, rejected Ernst & Whinney's statute of limitations argument, observing that "[Ernst & Whinney] now argues for the first time that [Bradford-White's] 10b-5 claim is barred by the applicable statute of limitations." It noted that the *Friedlander* decision was not controlling law and that it had been reported more than a month prior to the trial. Consequently, it found that "[Ernst & Whinney] presents a new issue not raised at trial, premised on a noncontrolling decision which was reported prior to trial." Thus, the court concluded that "the statute of limitations issue is not preserved and is deemed to have been waived." Bradford-White moved for partial reconsideration of the order of August 25, 1987, but its motion was denied by order of November 24, 1987.

Following the disposition of these motions we delivered our in banc opinion in *In re: Data Access Systems Securities Litigation*, 843 F.2d 1537 (3d Cir.), *cert. denied*, 109 S.Ct. 131 (1988), and a panel decision in *Hull v. Equitable Trust Co.*, 851 F.2d 691 (3d Cir. 1988), *cert. denied*, 109 S.Ct. 791 (1989). *Data Access* made clear that the statute of limitations in section 10(b) and Rule 10b-5 cases is the shorter of one year after the plaintiff discovers the facts constituting the violation or three years after the violation. In *Hill* we held that this limitations period, though shorter than that previously applied by this court, could be applied retroactively, at least in some circumstances. Thereafter, Ernst & Whinney moved for summary judgment on the securities law claim, contending that the statute of limitations barred the action. The district court granted this motion by order of September 12, 1988, thus terminating all proceedings in that court.[1] 699

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[1] We do not understand why the district court retreated from its earlier opinion of August 25, 1987, the court contemplated that there would be a second trial because of the irreconcilable answers to the interrogatories. While our opinion in *Data Access* undoubtedly gave legal support to the limitations defense, it could not have affected the factual circumstances which underlay the district court's finding of waiver – waiver and legal validity obviously constituting separate concepts. In its extensive memorandum opinion of September 12, 1988, granting summary judgment because of the limitations bar, the district court never mentioned its earlier finding that the defense had been waived. It opined that it would be inequitable to deny Ernst & Whinney a valid defense under *Data Access*, since it had pleaded the statute of limitations and it should not be forced "to litigate a claim which should be time-barred." 699 F.Supp. at 1090. But it is obvious that the court had been willing to force it to do exactly that when it ordered the new trial on August 25, 1987, since it found that the defense had been waived and not that it was invalid.

F.Supp. 1085 (E.D. Pa. 1988). Bradford-White then appealed from the orders of August 25, 1987, November 24, 1987, and September 12, 1988. Ernst & Whinney filed a protective cross-appeal from the order of August 25, 1987, insofar as that order denied its motions for amendment of the judgment on the securities law claim or for entry of a judgment notwithstanding the verdict on that claim in its favor.

We have appellate jurisdiction under 28 U.S.C. § 1291. The district court had jurisdiction under both 28 U.S.C. § 1331 and 15 U.S.C. § 78aa.

Inasmuch as we find that the jury's answers to the special interrogatories are reconcilable, we hold that the court erred in ordering a new trial on the securities law claim. Moreover, we find that Ernst & Whinney waived its affirmative defense under the statute of limitations by failing to raise it at the trial. Consequently, we will reverse and remand this case so that the judgment of July 25, 1986, may be reinstated as to the securities law claim. We thus do not review the judgment in favor of Ernst & Whinney on the state law claims as Bradford-White concedes that a judgment in its favor under the securities law claim gives it all the relief to which it is entitled. Accordingly, the balance of Bradford-White's appeal is moot. Finally, we will affirm the district court on the matters raised in Ernst & Whinney's cross-appeal.

I. BACKGROUND

At the time of events leading to this action, the W.L. Jackson Manufacturing Co., was in the business of manufacturing home water heaters. In the early 1970's Jackson

engaged Ernst & Whinney, a national accounting firm, to act as its independent auditor. Ernst & Whinney continued to serve in this capacity through a period including the transactions forming the basis of this action. In April 1981, Ernst & Whinney issued its opinion on Jackson's consolidated financial statements predicated on records through December 31, 1980. The April 1981, opinion stated that:

> [o]ur examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Ernst & Whinney's formal opinion also stated that, subject to certain exceptions and qualifications, the consolidated financial statements fairly presented Jackson's financial position "in conformity with generally accepted accounting principles applied on a consistent basis." On the basis of Jackson's December 1980, financial statements, as audited and certified by Ernst & Whinney, its net worth was $1,793,203.00.

In mid-June 1981, Bradford-White, which also manufactured home water heaters, began negotiating for the purchase of Jackson and at that time first saw Jackson's December 31, 1980, financial statements. The financial statements disclosed that Jackson was financially troubled; indeed, Bradford-White acknowledges in its brief that it knew "it was purchasing a troubled company." Bradford-White maintains that the information indicated that these problems were attributable to "a working capital problem due to inefficiency and improper management." As the district court explained in its August 25, 1987, opinion, Citicorp, Jackson's chief lender, imposed

time restrictions such that the acquisition had to be completed by June 22, 1981.

On June 21, 1981, Bradford-White concluded a Stock Purchase Agreement dated June 20, 1981, with Jackson's individual stockholders for the purchase of substantially all of its stock. The Agreement provided that the purchase price was to be determined on the basis of Jackson's June 30, 1981, net worth with a minimum purchase price and that Ernst & Whinney would again serve as the auditor of Jackson's financial statements.

Following the consummation of this Agreement, Ernst & Whinney conducted an audit of Jackson during which the extent of its financial problems became known. Bradford-White asserts that it became aware that Jackson had deeper and more significant financial problems than Bradford-White could reasonably have anticipated and that these problems had existed for some time but had been concealed in the certified financial statements. Ernst & Whinney's June 1981, audit concluded that Jackson's net worth was negative $3,606,647.00. Based on this decrease in net worth of over $5,300,000 in less than six months, Bradford-White contends that "it found itself in possession of an asset-depleted, liability-ridden company on the verge of bankruptcy." Bradford-White in its brief blames Ernst & Whinney for this situation contending that "[t]he false and misleading financial statements for the year-end December 1980 had masked the true state of the Jackson Co.'s financial condition." Ultimately, Jackson went through bankruptcy proceedings. In view of Jackson's negative net worth, Bradford-White became liable

under the Stock Purchase Agreement only for the floor price of the stock.[2]

As a result of the Ernst & Whinney reports, on July 14, 1983, Bradford-White filed the complaint in this action against Ernst & Whinney in the United States District Court for the Eastern District of Pennsylvania. On September 7, 1983, Ernst & Whinney filed its answer which included an affirmative defense that "[p]laintiff's claim is barred in whole or in part by the applicable statute or statutes of limitations and by the doctrine of laches."[3] Ernst & Whinney did not, however, indicate what it conceived was the "applicable" statute of limitations.

Following a thirteen day trial in July 1986, the district court submitted the case to the jury on eleven special interrogatories. Due to the importance of the exact wording of the special interrogatories and the jury's answers, we quote them in full:

> 1. Do you find by a preponderance of the evidence that Defendant Ernst & Whinney, in connection with its audit or opinion concerning the December 31, 1980 consolidated financial statements of the W.L. Jackson Manufacturing Company, made a material misrepresentation or a material omission with respect to any of the following:

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[2] In fact, Bradford-White negotiated a settlement and paid even less than this amount for the stock.

[3] The matter was before us previously after Ernst & Whinney obtained a summary judgment on the securities law count and a dismissal of the state law claims. We reversed and remanded for further proceedings. *See Bradford-White Corp. v. Ernst & Whinney*, 770 F.2d 1067 (3d Cir. 1985).

(a) Inventory [Yes]

(b) Accounts Receivable [No]

(c) Product Warranty Liability [Yes]

(d) Net Worth [Yes]

(e) Net Income (loss) [Yes]

(f) That Ernst & Whinney conducted its audit in accordance with generally accepted auditing standards [Yes]

(g) That the financial statements taken as a whole as qualified by the opinion of Ernst & Whinney presented fairly the financial position of the W.L. Jackson Manufacturing Company in accordance with generally accepted accounting principles [No]

If you have answered 'yes' to one or more of the above, proceed to question #2.

If you have answered 'no' to each of the above, proceed directly to question #6.

2. Do you find by a preponderance of the evidence that any of the representations or omissions were made *either* (1) with *knowledge* that the statement was false or misleading, or (2) with reckless indifference as to whether or not it was true? [Yes]

If your answer is 'yes' please identify by letter the particular item or items: [c,f] and then proceed to question #3.

If your answer is 'no' as to each item, proceed to question #6.

3. With regard to those items identified in your response to question #2, do you find by a preponderance of the evidence that Bradford-White (1) relied on the false statement or misleading omission in deciding to buy the stock of the W.L. Jackson Company, and (2) that it was reasonable to so rely? [Yes]

If your answer is 'yes' identify by the letter used above which item or items: [f] and then proceed to question #4.

If your answer is 'no' as to each item, proceed directly to question #6.

4. Were the representations by Ernst & Whinney made without any reasonable ground for believing it to be true and with the intent to induce others to rely upon it? [Yes]

Proceed to question #5.

5. Were the representations by Ernst & Whinney made with the intent to defraud others? [No]

Proceed to question #6.

6. Do you find by a preponderance of the evidence that Ernst & Whinney failed to use the care and skill ordinarily used in like cases by reputable members of the accounting profession practicing in the same or a similar locality, under similar circumstances? [Yes]

If your answer is 'yes' proceed to question #7.

If your answer is 'no' and you have answered 'no' to questions #1, #2, *or* #3, do not proceed any further.

If your answer is 'no' and if you have answered 'yes' to questions #1, #2, *and* #3, go directly to question #10.

7. Did Ernst & Whinney's failure as described in question #6, lead to a material misrepresentation or a material omission upon which Bradford-White relied? [Yes]

If your answer is 'yes' proceed to question #8.

If your answer is 'no' and you have answered 'no' to questions #1, #2, *or* #3, do not proceed any further.

If your answer is 'no' and if you have answered 'yes' to questions #1, #2, *and* #3, go directly to question #10.

8. Was Bradford-White contributorily negligent? [Yes]

If you have answered 'yes' proceed to question #9.

If your answer is 'no' proceed directly to question #10.

9. Do you find that Bradford-White's negligence is too far removed as to time or place or causative force to be a direct or proximate cause of the injury? [No]

If your answer is 'yes' proceed to question #10.

If your answer is 'no' and you have answered 'no' to questions #1, #2, *or* #3, do not proceed any further.

If you have answered 'yes' to questions #1, #2, *and* #3, proceed to question #10.

10. In what amount do you award damages? [$1,242,151]

Proceed to question #11 only if you have answered 'yes' to question #9.

11. State the amount by which the damages should be reduced to reflect Bradford-White's proportional contribution to the damages.[4]

Neither party requested that the matter be submitted for a general verdict in addition to answers to interrogatories and the district court did not so submit it. *See* Fed. R. Civ. P. 49(b). From the jury's answers the court molded a verdict and entered the judgment in favor of Bradford-White in the amount of $1,242,151.

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[4] The jury supplied no amount in answer to 11.

The post-trial proceedings which we have already described then ensued and this appeal followed. While numerous questions have been briefed on this appeal, we find that we need only determine whether the jury's answers to the special interrogatories were reconcilable and, if so, whether Ernst & Whinney may raise the statute of limitations as a defense.

II. THE JURY'S ANSWERS TO SPECIAL INTERROGATORIES

As we have stated, the court concluded that one of the jury's answers to the special interrogatories was irreconcilable with the other answers and consequently it ordered a new trial. Rulings on motions for a new trial are reviewable only for an abuse of discretion unless the court's denial of the motion is based on the application of a legal precept, in which case the review is plenary. *See Honeywell v. American Standards Testing Bureau*, 851 F.2d 652, 655 (3d Cir. 1988), *cert. denied*, 109 S.Ct. 795 (1989); *see also Link v. Mercedes-Benz of North America, Inc.*, 788 F.2d 918, 921 (3d Cir. 1986); *cf. Dent v. Cunningham*, 786 F.2d 173, 175 (3d Cir. 1986) (review of the selection, interpretation and application of legal precepts is plenary).

Here we conclude that the jury's answers may be harmonized. Thus, as the court was obliged as a matter of law for the reasons we will explain to enter a judgment in favor of Bradford-White, our review is plenary.

The jury's answers to the subparts of the first interrogatory established that Ernst & Whinney's audit or opinion of Jackson contained material misrepresentations or material omissions with respect to five elements: inventory, product warranty liability, net worth, net

income, and that the audit was conducted in accordance with generally accepted auditing standards (GAAS). The answer to the second interrogatory determined that the misrepresentations or omissions were made with scienter with respect to two elements: product warranty liability and that the audit complied with GAAS. The jury's answer to the third interrogatory found that Bradford-White reasonably relied on Ernst & Whinney's false statement or misleading omission that the audit complied with GAAS. Finally, the answer to the fourth interrogatory indicated that Ernst & Whinney made its representations without any reasonable ground to believe that it was true and with the intent to induce reliance. Taken together these answers constitute a finding of liability under Rule 10b-5 for the damages the jury found. *See Deutschman v. Beneficial Corp.*, 841 F.2d 502, 505-06 (3d Cir.), *cert. filed*, 57 U.S.L.W. 3062 (1988).

The crux of this finding of liability is that Ernst & Whinney failed to conduct an audit of Jackson which complied with GAAS but that it nonetheless represented that it had complied with GAAS. Ernst & Whinney maintains that this basis of liability cannot be reconciled with the jury's answer to special interrogatory 1(g) that there was no material misrepresentation or material omission such that "the financial statements taken as a whole . . . presented fairly the financial position of the W.L. Jackson Manufacturing Company in accordance with generally accepted accounting principles" (GAAP). Ernst & Whinney argues that this answer to special interrogatory 1(g) demonstrates that "the overall financials were not misstated" and that, taken as a whole, its reports accurately reflected Jackson's financial position and that the

findings of the jury are not contradictory. It therefore contends that on the basis of the jury's answers, it was entitled to entry of a judgment in its favor. We reject this interpretation as it stands in conflict with the jury's other answers which showed that the December 31, 1980, financial statements misrepresented or made material omissions as to inventory and product warranty liability and thus, not surprisingly, net worth and net income or loss. Accordingly, Ernst & Whinney's interpretation cannot possibly reflect the jury's intent. We also point out that Ernst & Whinney's interpretation is completely at odds with its own audits which showed a dramatic change in net worth between December 31, 1980, and June 30, 1981.

While we cannot accept Ernst & Whinney's interpretation of the answers to the interrogatories, we nevertheless are obliged to attempt to harmonize the answers, for it is well established that a verdict must be molded consistently with jury's answers to special interrogatories when there is any view of the case which reconciles the various answers. In *Atlantic and Gulf Stevedores, Inc. v. Ellerman Lines, Ltd.*, 369 U.S. 355, 82 S.Ct. 780 (1962), the Supreme Court instructed that:

> neither we nor the Court of Appeals can redetermine facts found by the jury any more than the District Court can predetermine them. For the Seventh Amendment says that 'no fact tried by a jury, shall be otherwise reexamined in any court of the United States, than according to the rules of the common law.'

369 U.S. at 358-59, 82 S.Ct. at 783.

Because of this deference to jury findings the Supreme Court explained:

> [w]here there is a view of the case that makes the jury's answers to special interrogatories consistent, they must be resolved that way. For a search for one possible view of the case which will make the jury's finding inconsistent results in a collision with the Seventh Amendment.

Id. at 363, 82 S.Ct. at 786 (citing *Arnold v. Panhandle & Sante Fe Ry. Co.*, 353 U.S. 360, 77 S.Ct. 840 (1957); *Dick v. New York Life Ins. Co.*, 359 U.S. 437, 79 S.Ct. 921 (1959)).

As our precedents make clear, deference to jury findings requires that we reverse a district court's erroneous conclusion that the jury's answers are in conflict. *See Barnhart v. Dollar Rent A Car Systems, Inc.*, 595 F.2d 914, 919 (3d Cir. 1979) ("[b]ecause a court must interpret a jury's findings of fact as consistent whenever possible, we believe that the district court erred in shaping its judgment in this case . . . . We therefore will vacate the judgment of the district court and will remand the case for entry of judgment . . . ."); *see also Scott v. Plante*, 641 F.2d 117, 124-25 (3d Cir. 1981) ("[s]ince the defendants did not in the trial court object to the form of the interrogatories either before or after the verdict, and do not on appeal argue that they were prejudiced by the way the questions were formulated, we must read them in a manner which reconciles them with the jurors' probable intention in light of the Court's instructions."), *vacated on other grounds*, 458 U.S. 1101, 102 S.Ct. 3474 (1982); *Jones & Laughlin Steel Corp. v. Johns-Manville Sales Corp.*, 626 F.2d 280, 293 (3d Cir. 1980) ("[i]f there exists 'a view of the case that makes the jury's answers to special interrogatories consistent, they must be resolved that way.' Since there is at least one way to explain the jury's answers to the interrogatories, we are bound to affirm them.");

Franklin Music v. American Broadcasting Co., 616 F.2d 528, 535 (3d Cir. 1979) ("[t]he role of this court in reviewing seemingly inconsistent answers to special interrogatories is to search for a reading of the jury's responses that makes them consistent").

Clearly, there is a way to harmonize the answer to 1(g) with the remainder of the answers. The jury found that Ernst & Whinney failed to follow GAAS when it did not uncover the misrepresentations or omissions with respect to inventory, product warranty liability, net worth, and net income. Nonetheless, the jury found that Ernst & Whinney complied with GAAP in the *presentation* of the incomplete data it had obtained as a result of the defective audit. This interpretation clearly harmonizes the answers as there is simply nothing irreconcilable in finding an auditor at fault for failing to uncover information but in concluding that it properly presented what it did find. Thus, the jury's finding on interrogatory 1(g) in no way undermined its answers to the other questions.[5]

There was ample evidence supporting this reading of the jury's answer to special interrogatory 1(g). As the district court noted in its memorandum resolving the post-trial motions, there was evidence that "had a GAAS

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[5] The court in the charge did not define GAAS and GAAP but there was no objection to this omission. Thus, while accountants may regard the terms as involving somewhat overlapping concepts, and may consider GAAP as including the concept of both valuation and disclosure, i.e., the material fairness of the auditor's representation, the jury was not bound by the court to that understanding. Thus, on the basis of the charge the jury was entitled to understand the word "presented" in interrogatory 1(g) to have its ordinary meaning.

audit been conducted, [Ernst & Whinney] would have uncovered material information as to inventory, product warranty liability, net worth and net income, all of which the jury concluded were materially misstated in the 1980 financial statements." Further, the court recognized there was evidence presented not only that Jackson's employees failed to provide documents to Ernst & Whinney during the audit but that Ernst & Whinney's "work papers reflect statements and documents supplied by management which were accepted by [Ernst & Whinney] without verification." On the other hand the jury could have concluded that the financial statements fairly presented the information obtained by Ernst & Whinney.

We are satisfied, therefore, that our reading of the jury's answers is not a mere post hoc rationalization. Consequently, we conclude that the district court erred in determining that the jury's answers to the special interrogatories could not be reconciled. Thus, it is evident that the order for the new trial on the securities law claim must be reversed and relief denied on Ernst & Whinney's defensive cross-appeal which seeks a judgment in its favor on that claim.

III. THE STATUTE OF LIMITATIONS

Our conclusion that a new trial should not have been ordered cannot in itself resolve this appeal because the court did, after all, ultimately conclude that the securities law claim was barred by the statute of limitations. 699

F.Supp. at 1091. Bradford-White, however, contends that Ernst & Whinney waived the limitations defense.[6]

Ernst & Whinney responds to the waiver contention by pointing out that it raised the statute of limitations defense in its answer. But while this is true, it did not file a motion or present argument before the district court on the statute of limitations issue at any time before or at the trial. At oral argument before this court we understood the attorney for Ernst & Whinney to state that a conscious, tactical decision had been made not to move for dismissal or for summary judgment on the limitations basis as such a motion would have somehow given credence to Bradford-White's claims, thus prejudicing Ernst & Whinney's defense on the merits.[7]

In the circumstances, it is clear that by the end of the trial Ernst & Whinney had waived any possible statute of limitations defense. As we have said, albeit in a diversity case under Pennsylvania law, "[t]he statute of limitations is an affirmative defense, and the burden of establishing its applicability to particular claim rests with the defendant." *Van Buskirk v. Carey Canadian Mines, Ltd.*, 760 F.2d 481, 487, 498 (3d Cir. 1985); *see also* Fed. R. Civ. P. 12(h)(2) and 51. Here, Ernst & Whinney simply did not attempt to establish this affirmative defense before or at trial. Obviously it would be grossly unfair to allow a plaintiff to go

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[6] Inasmuch as the claim of waiver raises legal questions, our review on the issue is plenary. *See Dent v. Cunningham*, 786 F.2d at 175.

[7] Even if Ernst & Whinney's failure to raise the defense was not a conscious, tactical decision our result on the waiver issue would be the same.

to the expense of trying a case only to be met by a new defense after trial. In this regard, we can hardly excuse Ernst & Whinney's failure to raise the defense on the circumstance that *Data Access* was decided after the trial and thus the bar of the statute may not have been apparent to it before or at the trial. The irony of such a ruling would be evident in view of our decision in *Hill v. Equitable Trust Co.*, 851 F.2d 691, applying *Data Access* retroactively to bar claims in that action. If *Data Access* may apply to complaints filed before it was decided then surely it may apply to waivers before it was decided as well. We could hardly hold that Bradford-White but not Ernst & Whinney should have anticipated *Data Access*.[8]

IV. CONCLUSION

In view of the aforesaid, we will reverse the order of August 25, 1987, to the extent that it granted Ernst Whinney a new trial on the securities law claim and we will reverse the order of November 24, 1987, denying Bradford-White's motion for reconsideration of the order

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[8] We also point out that a judgment notwithstanding the verdict could not be granted on the statute of limitations issue as there was no motion for a directed verdict on this ground. *See Orlando v. Billcon Int'l, Inc.*, 822 F.2d 1294, 1297-98 (3d Cir. 1987); *Bonjorno v. Kaiser Aluminum & Chemical Corp.*, 752 F.2d 802, 814 (3d Cir. 1984), *cert. denied*, 477 U.S. 908, 106 S.Ct. 3284 (1986). While later the court granted summary judgment on the statute of limitations issue we cannot be certain that Bradford-White would have been unable to present germane additional evidence on the point if a motion had been made for a directed verdict. *See Levinson v. Prentice-Hall, Inc.*, No. 88-5637, slip op. at 10, 868 F.2d 558 (3d Cir. Feb 14, 1989).

of August 25, 1987, to that extent. We will also reverse the order of September 12, 1988, granting Ernst & Whinney summary judgment. We will, therefore, remand the case to the district court so that judgment may be entered on the federal securities law claim for $1,242,151 as of July 25, 1986, in favor of Bradford-White against Ernst & Whinney. We will dismiss the rest of Bradford White's appeal as moot. We will affirm the order of August 25, 1987, to the extent that Ernst & Whinney has appealed from it. Finally, we will remand for entry of an order consistent with this opinion.

IN THE UNITED STATES DISTRICT COURT

FOR THE EASTERN DISTRICT OF PENNSYLVANIA

BRADFORD-WHITE CORPORATION	:	CIVIL ACTION
	:	NO. 83-3371
v.	:	
ERNST & WHINNEY	:	

SPECIAL INTERROGATORIES

1. Do you find by a preponderance of the evidence that Defendant Ernst & Whinney, in connection with its audit or opinion concerning the December 31, 1980 consolidated financial statements of the W. L. Jackson Manufacturing Company, made a material misrepresentation or a material omission with respect to any of the following:

(a)	Inventory	Yes	✓	No ___
(b)	Accounts Receivable	Yes	___	No ✓
(c)	Product Warranty Liability	Yes	✓	No ___
(d)	Net Worth	Yes	✓	No ___
(e)	Net Income (Loss)	Yes	✓	No ___
(f)	That Ernst & Whinney conducted its audit in accordance with generally accepted auditing standards	Yes	✓	No ___

(g) That the financial statements taken as a whole as qualified by the opinion of Ernst & Whinney presented fairly the financial position of the W. L. Jackson Manufacturing Company in accordance with generally accepted accounting principles Yes ___ No ✓

If you have answered "yes" to one or more of the above, proceed to question #2. If you have answered "no" to each of the above, proceed directly to question #6.

2. Do you find by a preponderance of the evidence that any of the representations or omissions were made *either* (1) with *knowledge* that the statement was false or misleading, or (2) with reckless indifference as to whether or not it was true?

Yes ✓ No ___

If your answer is "yes" please identify by letter the particular item or items: cf

and then proceed to question #3.

If your answer is "no" as to each item, proceed to question #6.

3. With regard to those items identified in your response to question #2, do you find by a preponderance of the evidence that Bradford-White (1) relied on the false statement or misleading omission in deciding to buy the stock of the W. L. Jackson Company, and (2) that it was reasonable to so rely?

Yes ✓ No ___

If your answer is "yes" identify by the letter used above which item or items: f

and then proceed to question #4.

If your answer is "no" as to each item, proceed directly to question #6.

4. Were the representations by Ernst & Whinney made without any reasonable ground for believing it to be true and with the intent to induce others to rely upon it?

Yes ✓ No ___

Proceed to question #5.

5. Were the representations by Ernst & Whinney made with the intent to defraud others?

Yes ___ No ✓

Proceed to question #6.

6. Do you find by a preponderance of the evidence that Ernst & Whinney failed to use the care and skill ordinarily used in like cases by reputable members of the accounting profession practicing in the same or a similar locality, under similar circumstances?

Yes ✓ No ___

If your answer is "yes" proceed to question #7.

If your answer is "no" and you have answered "no" to questions #1, #2 *or* #3, do not proceed any further.

If your answer is "no" and if you have answered "yes" to questions #1, #2 *and* #3, go directly to question #10.

7. Did Ernst & Whinney's failure as described in question #6, lead to a material misrepresentation or a material omission upon which Bradford-White relied?

Yes ✓ No ___

If your answer is "yes" proceed to question #8.

If your answer is "no" and you have answered "no" to questions #1, #2 *or* #3, do not proceed any further.

If your answer is "no" and if you have answered "yes" to questions #1, #2 *and* #3, then proceed to question #10.

8. Was Bradford-White contributorily negligent?

Yes ✓ No ___

If you have answered "yes" proceed to question #9.

If your answer is "no" proceed directly to question #10.

9. Do you find that Bradford-White's negligence is too far removed as to time or place or causative force to be a direct or proximate cause of the injury?

Yes ___ No ✓

If your answer is "yes" proceed to question #10.

If your answer is "no" and you have answered "no" to questions #1, #2 *or* #3, do not proceed further.

If you have answered "yes" to questions #1, #2 *and* #3, proceed to question #10.

10. In what amount do you award damages?

$ 1, 242, 751

Proceed to question #11 only if you have answered "yes" to question #9.

11. State the amount by which the damages should be reduced to reflect Bradford-White's proportional contribution to the damages.

$ _____

_____

Foreman

McG/abv

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

BRADFORD-WHITE CORPORATION	:	CIVIL ACTION
v.	:	
ERNST & WHINNEY	:	NO. 83-3371

ORDER

(Filed September 13, 1988)

AND NOW, this 12th day of SEPTEMBER, 1988, upon consideration of the Defendant's Motion for Summary Judgment and the Plaintiff's response thereto, it is

ORDERED

that the Defendant's Motion is GRANTED and the Plaintiff's claims are DISMISSED.

BY THE COURT

/s/ Joseph L. McGlynn, Jr.
JOSEPH L. McGLYNN, JR. J.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

BRADFORD-WHITE CORPORATION	:	CIVIL ACTION
v.	:	
ERNST & WHINNEY	:	NO. 83-3371

MEMORANDUM OF DECISION

McGLYNN, J. SEPTEMBER 12, 1988

Presently before the court is the defendant's motion for summary judgment. Plaintiff initiated this action in July, 1983 alleging a cause of action under §10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder and pendent state law claims for intentional misrepresentation, negligent misrepresentation and professional malpractice. Following a 13-day trial, the jury answered special interrogatories from which the court molded a verdict and entered judgment in favor of Bradford-White in the amount of $1,242,151.

In disposing of several post-trial motions, I granted the defendant's motion to amend judgment in the defendant's favor with respect to the pendent state law claims. I also granted the defendant's motion for a new trial with respect to the plaintiff's securities claims. The defendant now moves for summary judgment contending that in light of the Third Circuit's recent decisions in *In Re: Data Access Systems Securities Litigation*, 843 F.2d 1537 (3d Cir. 1988) and *Hill v. Equitable Trust Co.*, No. 87-3575, Slip Op. (3d Cir. July 14, 1988) (1988 Lexis U.S. App. Lexis 9489), the plaintiff's claims are time-barred.

Background

The factual background giving rise to this litigation has been detailed in previously filed memoranda and only the facts necessary to a determination of the pending motion will be recited here.

The plaintiff, Bradford-White Corporation, is a Tennessee corporation which manufactures and distributes

domestic and commercial water heaters. The defendant, Ernst & Whinney, is a national accounting firm which prepared financial statements which the plaintiff alleges contained material misrepresentations and omissions.

In June 1981, the plaintiff was interested in acquiring the W. L. Jackson Company ("Jackson Company"), a private Tennessee Corporation which operated a water heater manufacturing plant in Chattanooga, Tennessee, and with the approval of the U. S. Justice Department arranged a meeting attended by representatives of both corporations. Due to time constraints imposed by Citicorp, the Jackson Company's primary lender, the acquisition had to be completed by June 22, 1981. Accordingly, the parties entered into a week of intense negotiations which culminated in the execution of a stock purchase agreement. Signed on June 21, 1981, but dated June 20, 1981, the agreement provided that the price of the Jackson Company stock would be determined by an audit of the company as of June 30, 1981.

Prior to executing this agreement, a consultant for the Jackson Company provided the plaintiff with the Jackson Company's financial statements, which had been prepared by the defendant and dated December 31, 1980, as well as interim financial statements through April 30, 1981. These statements were characterized as being prepared in accordance with generally accepted accounting principles and to fairly and accurately portray the financial condition of the Jackson Company. The statements disclosed a working capital deficiency, a potential warranty liability problem, a net operating loss of $1,097,427 in 1980 and a net worth of $1,793,203 in 1980.

The record reveals that, subsequent to executing the agreement, the plaintiff became aware that the financial

health of the Jackson Company was worse than pictured. In August, 1981, when the results of the June audit were made available, the defendant issued an opinion of the Jackson Company's financial condition which was significantly different from that contained in the December 31, 1980 financial statements. Nevertheless, the plaintiff continued to abide by the terms of the agreement. In October, 1981, the financial problems proved to be too great and the plaintiff filed a voluntary petition in bankruptcy on behalf of the Jackson Company. There was no improvement and plaintiff was forced to liquidate the Jackson Company in April, 1982. The plaintiff filed this action on July 14, 1983.

Discussion

In *In re: Data Access Securities Litigation*, 843 F.2d 1537 (3d Cir. 1988), the Third Circuit answered the "troublesome question," faced several times earlier in this circuit, of determining the correct statute of limitations for causes of action arising under §10(b) of the securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 promulgated thereunder. *Data Access*, 843 F.2d at 1537. The court held that the limitations period for "a complaint charging violation of section 10(b) and Rule 10b-5 is one year after the plaintiff discovers the facts constituting the violation and in no event more than three years after such violation." *Id.* at 1550. In deciding the defendant's motion for summary judgment, I am required to decide whether the Third Circuit's decision in *Data Access* should be applied retroactively to the facts of this case, and if so, when the plaintiff discovered the facts which

constituted the securities violation, thus giving rise to its cause of action.

A. *The Chevron Factors: Retroactive application of DATA ACCESS*

In *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971) the Supreme Court summarized three factors to be considered in determining whether to apply a judicial decision retroactively. In applying these factors to this case, however, I am not writing on a clean slate. In *Hill v. Equitable Trust Co.*, No. 87-3575, slip op. (3d Cir. July 14, 1988), a Third Circuit panel unanimously applied *Data Access* retroactively to bar the plaintiffs' §10(b) and Rule 10b-5 claims. Although *Hill* does not dictate the result here, the court's analysis of the *Chevron* factors is instructive.

1. *Did Data Access Change Prior Law?*

The first *Chevron* factor is whether a decision establishes a new principle of law, either by overruling clear past precedent or by deciding an issue of first impression whose resolution was not clearly foreseeable. In answering this question, I must look to the state of the law when the plaintiff's cause of action arose. *See Hill*, No. 87-3575, slip op., at 11-12; *Al-Khazraji v. Saint Francis College*, 784 F.2d 505, 512 & n. 9 (3d Cir. 1986), *aff'd.*, 107 S.Ct. 1022 (1987); *Perez v. Dana Corp.*, 718 F.2d 581, 686 (3d Cir. 1983); *see also Data Access*, 843 F.2d at 1557 (Seitz, J., dissenting) (looking to state of law when third amended complaint was filed but noting that date of filing is not relevant date in all cases). In this case, the state of the law at the time

the plaintiff's claim arose can be gleaned from the Third Circuit's opinions in *Roberts v. Magnetic Metals Co.*, 611 F.2d 450 (3d Cir. 1979); *Biggans v. Bache Halsey Stuart Shields, Inc.*, 638 F.2d 605 (3d Cir. 1980); and *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

If I were deciding this case without the benefit of the Third Circuit's recent analysis in *Hill*, the plaintiff's argument that the law was clearly established when its claim accrued would be more persuasive. In fact, the plaintiff's position is supported by Judges Seitz, Sloviter and Mansmann in the dissenting opinion of *Data Access*, 843 F.2d at 1553. Although at the time the plaintiff's claim accrued the Third Circuit had not selected one specific limitations period, it did take an *ad hoc*, functional, claim-matching approach by first determining whether the action could have been brought under the state Blue Sky Laws. If the plaintiff could not bring a cause of action under the state Blue Sky Laws, then the court was to apply the statute of limitations for common law fraud. *Id.* (Seitz, J., dissenting); *see also Sowell v. Butcher & Singer, Inc.*, No. 87-0714 Slip Op., at 9 n. 4 (E.D. Pa. May 12, 1987) (Judge Scirica stating he was bound by *Biggans*); *Dofflemeyer v. W. F. Hall Printing Co.*, 558 F. Supp 372, 377 (D. Del. 1983) (opinion by Judge Stapleton implying a clear result from application of *Roberts* and *Biggans*); *cf. Ging v. Parker-Hunter Inc.*, 544 F. Supp. 49, 51 (W.D. Pa. 1982) (characterizing *Biggans* as "controlling" under facts of that case).

After reviewing the *Roberts* and *Biggans* opinions, along with (then) Chief Judge Latchum's opinion in *Hill v. Der*, 521 F. Supp. 1370 (D. Del. 1981), the *Hill* court concluded that "[c]lear holdings on which plaintiffs could

rely, as in *Al-Khazraji* and its progeny, were absent when plaintiffs decided to begin this suit in (April) 1982." Even if I assume, *arguendo*, that the plaintiff's claim here did not accrue until it filed suit in 1983[1], I find no decisions in the Third Circuit between April 1982 and July 1983 when this suit was filed which settled the law with respect to the statute of limitations in 10b-5 cases. In fact, the lack of clarity surrounding the appropriate statute of limitations for claims alleging violations of §10(b) and Rule 10b-5 has been noted by numerous district courts within the Third Circuit since the *Biggans* case was decided. *See, e.g., Cohen v. McAllister*, 673 F.Supp. 733, 736 (W.D. Pa. 1987) (describing *Biggans* analysis as "fraught with ambiguity" resulting in "uncertainty among potential plaintiffs and defendants as to the timeliness of §10(b) claims"); *Steinberg v. Shearson Hayden Stone, Inc.*, 598 F. Supp. 273 (D. Del. 1984) (applying *Biggans* and *Roberts* but noting disagreement among judges); *Goodman v. Moyer*, 523 F. Supp. 35, 37 (E.D. Pa. 1981) (quoting *Biggans*, 638 F.2d at 607 (Weis, J., dissenting)) (characterizing *Biggans* limitation selection process as "confused and inconsistent body of law").

In 1981, in *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), a case not discussed by the *Hill* court, a unanimous panel of the Third Circuit applied *Biggans* to hold a §10b and Rule 10b-5 claim to be timely filed by

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[1] As Judge Seitz noted in his *Data Access* dissent, the date of filing the complaint is not necessarily the "critical date in applying the *Chevron* factors." *Data Access*, 843 F.2d 1553 (Seitz, J., dissent). I selected the date of filing, however, to show that even at this late date the law in the Third Circuit, based upon the *Hill* court's analysis, was still unclear.

applying the six-year fraud statute of limitations. *Id.*, at 192. Applying the *Hill* court's reasoning, since the *Sharp* decision was unanimous, one could argue that *Sharp* did much to clarify the law in this area.

Such a simplistic analysis, however, proves too much. To say that the law in this area was clear after the *Sharp* opinion is directly contrary to the *Hill* court's statement that the law was not clear at the time the Hill plaintiffs filed their claim in April 1982. *Hill*, No. 87-3575, Slip Op. at 13. While it is pure speculation as to why the *Hill* court did not discuss *Sharp*, the answer probably lies in the fact that the *Sharp* opinion provided little analysis for the court to consider. Moreover, the *Sharp* court applied *Biggans* because it was "not distinguishable" from the facts of *Sharp*. *Sharp*, 649 F.2d at 192. Thus, the *Sharp* court did not have occasion to revisit the *Roberts* and *Biggans* analysis. As the *Hill* court noted, the problem with the *Roberts* and *Biggans* line of cases was that the analysis left considerable room for variation in different factual situations which, on occasion, led to inconsistent results. *See, e.g., Eisenberg v. Gagnon*, 564 F.Supp. 1347, 1357 (E.D. Pa. 1983) (Court applying different limitations period for different defendants). *See Data Access*, 843 F.2d at 1541; *Cohen*, 673 F.Supp. at 736; *Hill v. Der*, 521 F.Supp. at 1382-83. Thus, due to the factual similarity between *Biggans* and *Sharp*, the *Sharp* opinion did little to settle the uncertainty.

In addition to the uncertainty discussed by the *Hill* court, at the time the plaintiff's claim arose there was also uncertainty surrounding the length of the state law statute of limitations for common law fraud. This uncertainty was noted by the *Biggans* court, *Biggans*, 638 F.2d at 607 n.2, and by several district courts during the time period

which the facts of this case were unravelling. *See, e.g., Fickinger v. C.I. Planning Corp.*, 556 F. Supp 434, 438 (E.D. Pa. 1981) (noting Pennsylvania statute of limitations was unclear and applying two year limitations period); *Culbreth v. Simone*, 511 F.Supp. 906 (E.D. Pa. 1981) (Applying six year limitations period disagreeing with *Fickinger*); *but see D'iorio v. Adonizio*, 554 F.Supp. 222, 232 (M.D. Pa. 1982) (relying on *Biggans* to apply the six year limitations period without discussion). Based on this case law, the plaintiff could not be certain that the six year Pennsylvania statute of limitations would apply to its suit until 1986 when the Third Circuit decided *A.J. Cunningham Packing v. Congress Financial Corp.*, 792 F.2d 330 (3d Cir. 1986).

Accordingly, as the Third Circuit ruled in *Hill*, I find that under the facts of this case, the first prong of the *Chevron* test favors retroactive application of *Data Access*.

2. *The Purpose of the DATA ACCESS Ruling*

The second part of the *Chevron* test required that "the merits and demerits in each case be weighed by looking to the prior history of the rule in question, its purpose and effect, and whether retroactive operation will further or retard its operation will further or retard its operation. *Pratt v. Thornburgh*, 807 F.2d 355, 358 (3rd Cir. 1986), *cert. denied*, 108 S.Ct. 125 (1987). In *Hill*, the court assumed that on the facts of that case the resolution of the second *Chevron* factor was neutral. *Hill*, No. 87-3575, Slip Op., at 14 (citing *Al-Khazraji*, 784 F.2d at 513; *Fitzgerald v. Larsen*,

769 F.2d 160, 164 (3d Cir. 1985)). In this case, I find no reason to depart form the *Hill* court's conclusion.[2]

3. *The Equities of Retroactive Application*

The final factor to be considered in the *Chevron* analysis requires me to weigh the inequity imposed by retroactive application, if any. Application of this factor, however, is not controlled by precedent, but instead depends upon the facts and equities of each case. *Dian v. United Steelworkers of America*, 633 F. Supp. 1059, 1058 (E.D. Pa.), *aff'd*, 806 F.2d 252 (3rd Cir. 1986).

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[2] The purposes of the *Data Access* decision, i.e., promoting uniformity and avoiding untimely, time-consuming litigation and uncertainty, were the same as the purposes behind the Supreme Court's decisions in *Wilson v. Garcia*, 471 U.S. 261 (1985), and *Agency Holding Corp. v. Malley-Duff & Assoc.*, 107 S. Ct. 2759 (1987). *See Data Access* 843 F.2d at 1549 (citing *Roberts*, 611 F.2d at 463 (Seitz, J. dissenting). In cases where the first *Chevron* factor was not met, the Third Circuit has retroactively applied *Wilson* and *Malley-Duff*, finding that to do so would promote the purposes behind those Supreme Court decisions. *See Smith v. City of Pittsburgh*, 764 F.2d 188 (3d Cir.) (applying *Wilson* retroactively), *cert. denied*, 106 S.Ct. 349 (1985); *Gonzalez v. Katz*, No. 86-7254, Slip Op. (E.D. Pa. August 13, 1987) (applying *Malley-Duff* retroactively), aff'd mem., No. 87-1550, Slip. Op. (3d Cir. March 23, 1988). Accordingly, I am satisfied that the purposes of *Data Access* would be promoted by the retroactive application of that decision, even though this case is already in litigation. *See Smith*, 764 F.2d at 196. Nevertheless, because this case already has produced one lengthy trial, I cannot find that the policies of *Data Access* either clearly favor of disfavor retroactive application.

The Third Circuit has continually stated that the third Chevron factor overlaps the first factor because it would be inequitable to apply retroactively a limitations period which changed established law. *See Fitzgerald*, 769 F.2d at 164 (3rd Cir. 1985). In this case, I have determined that the law was not clearly established when the plaintiff's claim accrued. Thus, according to the reasoning in *Fitzgerald*, there is little or no inequity in applying *Data Access* retroactively.

Two additional considerations, however, make resolution of this third factor more difficult. First, in *Hill*, the Third Circuit stated that the third factor of *Chevron* was the plaintiffs' weakest position because the plaintiffs would have faced the same outcome whether or not the *Data Access* limitations period was applied. This, however, cannot be said for the plaintiff in the case *sub judice*. It is now clear that if the *Data Access* limitations period were applied here, the plaintiff would witness a five year shortening in the applicable limitations period.[3]

Second, in applying the third *Chevron* factor, courts often examine the posture of the case, including the time and money expended in the litigation and whether by applying the new principle of law retroactively the court will be rewarding a party for unexcused delay. *See Perez*, 718 F.2d at 588 (discussing *Chevron*, 404 U.S. 97 (1971));

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[3] Both parties admit that if the plaintiff's claim were governed by the Pennsylvania statute of limitations for common law fraud, the limitations period would be six years. *Cunningham*, 792 F.2d at 335-36. Even if the shorter two-year statute of limitations period applied, the plaintiff's claim would still be shortened by one year due to the *Data Access* decision.

Dian, 633 F. Supp. at 1060-61. In this case neither party is guilty of procrastination or unexcused delay. At the same time, however, it is clear that considerable time and money has been expended in the prosecution of this claim. Finally, substantially all of the preparation for the new trial, which was granted based on inconsistent answers to special interrogatories submitted to the jury at the first trial, has been completed.

I am not persuaded that these consideration preclude retroactive application. Although the *Data Access Systems* decision did shorten the statute of limitations applicable to the plaintiff's claim, the fact remains that, as I concluded earlier, the law relating to the statute of limitations was "in ferment" at the time their claim accrued. *See Hill*, No. 87-3575, slip. op., at 13. Thus, even though the limitations period was shortened, this is no different than other decisions in which a statute of limitations was retroactively applied despite the fact that the perceived limitations period was thereby shortened. *See, e.g., Perez*, 718 F.2d at 588 (applying *DelCostello* retroactively limiting limitations period proposed by plaintiff); *Smith*, 764 F.2d at 194-197.

Moreover, while much money and time has been expended on this case, the money and time was expended by both sides. Neither side can be faulted for delaying the case. Thus, while it is unfortunate that the plaintiff may lose its day in court due to the retroactive application of *Data Access*, it would be inequitable to deny the defendants a valid defense, which was pleaded earlier in the case, thus forcing it to litigate a claim which should be time-barred. Finally, while courts have considered the additional factors, I have found no cases in which a

finding of retroactivity was based on these factors alone, especially when the first *Chevron* fact was not met.

Accordingly, it is my conclusion that the application of the several *Chevron* factors[4] in this case does not support an exception to the general rule of applying the Law in force at the time a decision is rendered. *See Hill*, No. 87-3575, Slip Op., at 8; *Lund v. Shearson/Lehman*, No. 87-1920, Slip Op., at 2 (6th Cir. July 20, 1988). The decision of the Third Circuit in *Data Access Systems* will be applied retroactively in this case.[5] *See also Cohen v. McAllister*, No. 87-90, slip op. (W.D. Pa. June 22, 1988).

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[4] Several courts have stated that the most important factor of the *Chevron* test is the first factor. *Lund v. Shearson/Lehman*, No. 87-1920, Slip Op., at 3 (6th Cir. July 20, 1988); *John Does 1-100 v. Ninneman*, 634 F. Supp. 341, 342 n. 4, 344 (citing *Farmer v. Cook*, 782 F.2d 780, 781 (8th Cir. 1986). Moreover, it has been stated that in applying the *Chevron* factors, if the "first and most important" factor, *John Does*, 634 F. Supp. at 344, is not satisfied, the rule of law at issue will be applied retrospectively without further analysis. *Lund*, No. 87-1920, Slip Op. at 3 (citing *United States v. Johnson*, 457 U.S. 537, 550 n.12 (1982)). Despite this case law, I have given the plaintiffs the benefit of applying all three *Chevron* factors.

[5] I am aware of the recent opinion in this district in which Judge Ditter ruled that *Data Access* would not be applied retrospectively. *ITG, Inc. v. Price Waterhouse*, No. 86-6332, Slip Op. (E.D. Pa. September 7, 1988); *Gruber v. Price Waterhouse*, No. 86-3976, Slip Op. (E.D. Pa. August 26, 1988). In both opinions, however, Judge Ditter relied heavily on the Third Circuit's decision in *Sharp*, 649 F.2d at 191-92, and stated that the *Sharp* decision created clear precedent upon which the plaintiffs in those cases could rely. *Gruber*, No. 86-6332, Slip

(Continued on following page)

B. *Commencement of the statute of limitations*

Having decided to apply the decision in *Data Access* retroactively, I now must determine when the statute began to run. If the limitations period commenced prior to July 14, 1982, the plaintiff's claim is time-barred. Plaintiff argues that this is an issue of fact which must be decided by the jury on a more fully developed record relating to this specific issue. The defendant, relying on the extensive record developed at the first trial, maintains that the statute began to run, at the latest, on January 29, 1982.

In *Data Access*, the Third Circuit stated that in § 10(b) and Rule 10b-5 claims the limitations period "is one year after the plaintiff *discovers the facts constituting the violation* and in no event more than three years after such violation." *Data Access*, 843 F.2d at 1550 (emphasis added). I interpret this language to be consistent with the general rule that the limitations period commences when the plaintiff is aware of facts which point to fraud or when the possibility of fraud is or should be apparent. *Hill v. Equitable Bank*, 655 F. Supp. 631, 640-41 (D. Del.

(Continued from previous page)

Op., at 8-10; *ITG, Inc.*, No. 86-6332, Slip Op., at 3. *Sharp*, however, was a 1981 decision. The *Gruber* and *ITG* opinions did not address the Third Circuit's statement in *Hill* that "[c]lear holdings on which plaintiffs could rely . . . were absent in [April] 1982." *Hill*, No. 86-6332, Slip Op., at 13. Moreover, in *Gruber*, Judge Ditter conceded that in some situations, the law as represented by *Biggans* and *Roberts* may have been unsettled. *See Gruber*, No. 86-3976, Slip Op., at 8. Accordingly, I decline to follow *Gruber* and *ITG, Inc.*

1987); *Fickinger*, 556 F. Supp. at 439. In other words, the knowledge required by a plaintiff in order to commence the running of the statute of limitations "'is merely that of the *facts* forming the *basis* of his cause of action, . . . not that of the existence of the cause of action itself.' " *Jensen v. Snellings*, 841 F.2d 600, 606 (5th Cir. 1988) (citing *Vigman v. Community National Bank & Trust Co.*, 635 F.2d 455, 459 (5th Cir. 1981)) (emphasis in original). The plaintiff cannot ignore "storm warnings", *Cook v. Avien, Inc.*, 573 F.2d 685, 697 (1st Cir. 1978), and await the leisurely discovery of this claim. *Jensen*, 841 F.2d at 607.

Based upon the record in this case, I find that sufficient "warnings" existed well before July 14, 1982 from which the plaintiff could foresee not merely a financial storm, but a financial hurricane. The record is clear that the plaintiffs were aware of facts no later than January 1982 which constituted the violations upon which this suit is based. For example, in August, 1981, the president of Bradford-White, stated in a letter to a creditor's representative that there was a serious deficiency in the inventory of the Jackson Company. *DeLuca Notes of Testimony (N.T.)*, July 10, 1986, at 35-37. Moreover, he testified that in July, 1981 it was clear that there was no relationship between what plaintiff expected based on the financial statements and what was actually present, and that the financial problems the Jackson Company faced were much more severe than anticipated. *N.T.* DeLuca, July 8, 1986, at 121. Finally, there is testimony in the record which suggests that the only reason the plaintiff did not file suit as early as January, 1982 was because of a desire to reorganize the company and because the damages were perceived to be unclear. *N.T.*, July 17, 1986 at 85-86.

The very fact that the plaintiffs were considering filing suit at that time, however, leads to the conclusion that they knew of the facts which constituted the alleged Securities Act violations.

While courts generally refrain from granting summary judgment on the issue of when a statute of limitations commenced, summary judgment can be granted with respect to this issue when the record supports such a finding. *Hill*, 655 F. Supp. at 641; *see also General Builders Supply Co. v. River Hill Coal*, 796 F.2d 8, 13 (1st Cir. 1986). There can be no doubt that by January 1982, if not before, plaintiff knew of the facts which constituted the basis for this law suit.

Accordingly, I will grant the defendant's motion for summary judgment. An appropriate order follows.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

BRADFORD-WHITE CORPORATION	:	CIVIL ACTION
	:	NO. 83-3371
v.	:	
ERNST & WHINNEY	:	

ORDER

AND NOW, this 25th day of August, 1987, upon consideration of the defendant, Ernst & Whinney's motion to amend the judgment or, in the alternative, for judgment notwithstanding the verdict or for a new trial and plaintiff, Bradford-White Corporation's conditional motion for new trial, for the reasons stated in the accompanying memorandum, it is

ORDERED that:

1. Defendant's motion to amend the judgment in its favor with respect to the claim under § 10(b) of the Securities and Exchange Act of 1934 and SEC-Rule 10b-5 is DENIED;

2. Defendant's motion to amend the judgment in its favor with respect to the pendent state law claims is GRANTED;

3. The judgment entered herein, dated July 25, 1986, in favor of plaintiff and against defendant in the amount of $1,242,151 (Docket Entry No. 72) is AMENDED to read in favor of defendant and against plaintiff with respect to the pendent state law claims;

4. Defendant's motion for judgment notwithstanding the verdict is DENIED;

5. Defendant's motion for new trial with respect to the claim under § 10(b) of the Securities and Exchange Act of 1934 and SEC-Rule 10b-5 is GRANTED;

6. Plaintiff's conditional motion for new trial with respect to all claims is DENIED; and

7. The judgment entered herein, dated July 25, 1986, in favor of plaintiff and against defendant in the amount of $1,242,151 (Docket Entry No. 72) is VACATED with respect to the claim under § 10(b) of the Securities and Exchange Act of 1934 and SEC-Rule 10b-5, and a new trial shall be held as to that claim only.

/s/ Joseph L. McGlynn
JOSEPH L. McGLYNN, JR., J.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

BRADFORD-WHITE CORPORATION	:	CIVIL ACTION
	:	NO. 83-3371
v.	:	(Filed August 26, 1987)
ERNST & WHINNEY	:	

MEMORANDUM OF DECISION

McGLYNN, J. AUGUST 25, 1987

Plaintiff, Bradford-White Corporation ("BWC") initiated this action against defendant, Ernst & Whinney ("E&W"), alleging a cause of action under § 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission and pendent state law claims for intentional

misrepresentation, negligent misrepresentation and professional malpractice. Following a 13-day trial, the jury answered special interrogatories from which the court molded a verdict and entered judgment in favor of BWC and against E&W in the amount of $1,242,151. E&W now moves to amend the judgment by molding the jury's responses to the interrogatories in its favor. Should this motion be denied, E&W moves in the alternative for judgment notwithstanding the verdict or for a new trial. BWC, in turn, moves to amend the judgment as entered to include prejudgment interest. BWC has also filed a conditional motion for new trial as to all claims in the event the court molds the verdict in favor of the defendant, E&W.

BACKGROUND

BWC is a Tennessee corporation which manufactures and distributes domestic and commercial water heaters. In June, 1981, BWC conducted its manufacturing operations at a single plant in Middleville, Michigan and have five regional distribution centers located throughout the United States.

Since 1972, BWC desired to obtain an existing manufacturing facility in the southeastern United States where its market share was not as strong as it was in other parts of the country. For almost ten years, BWC had been unsuccessful in attempting to acquire the W. L. Jackson Company ("Jackson Co."), a private Tennessee corporation, which owned and operated a water heater manufacturing plant Chattanooga, Tennessee. The Jackson Co., while the smallest competitor in the industry with 5% of

the market share, was particularly attractive to BWC because of the favorable freight advantage which its Chattanooga plant provided to markets in the southeastern states. On June 21, 1981,[1] BWC acquired the Jackson Co. by entering into a Stock Purchase Agreement ("Agreement") with the shareholders of the Jackson Co., William H. Jackson, Bernard Jackson and Robert Jackson ("Jacksons"). Exhibit P-5.

At the heart of this dispute are certified financial statements of the Jackson Co. and its subsidiaries for the year ending December 31, 1980 (Exhibit P-1), which were presented to BWC by the Jacksons in the course of the negotiations. These financial statements contained misrepresentations and omissions. The statements were prepared for the Jackson Co. by E&W, a national accounting firm which maintains an office in Chattanooga. Events both prior and subsequent to the signing of the Agreement provide the framework of this lawsuit.

I. *Pre-Agreement*

In 1980, the Jackson Co. had fallen behind in payments to its suppliers and creditors and was on the verge of bankruptcy. The company had been experiencing a working capital deficiency which was further exacerbated when the company defaulted on long-term loan obligations to its primary lender, Citibank, and the outstanding principal balance on the debt was converted to a current liability.

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[1] The Agreement is dated June 20, 1981 but was executed on June 21, 1981.

Because Citibank's willingness to continue financing the Jackson Co. was critical to the company's ability to operate, Citibank was directly involved in negotiations between the prospective purchasers of Jackson Co. and the Jacksons. In the early months of 1981, four different companies, including BWC and Mor-Flo Industries, were attempting to acquire Jackson Co. In June, 1981, Mor-Flo Industries was close to concluding an agreement to purchase Jackson Co. A pre-merger notification report was filed by Jackson Co. with the United States Department of Justice and Federal Trade Commission seeking clearance on the basis of the failing company doctrine.[2]

On Tuesday, June 16, 1981, the Justice Department informed BWC that Mor-Flo's efforts to acquire Jackson Co. had collapsed and inquired whether BWC would be interested in purchasing the company. BWC immediately contacted Jackson Co. and opened negotiations.

On Wednesday, June 17, 1981, BWC's president, Michael R. DeLuca, counsel, Ronald N. Middleton, and operations manager, Fred Pellegrine, met with Frank Carter, a consultant for Jackson Co. and the company's former president, in Birmingham, Alabama. At this meeting, Mr. Carter provided the BWC representatives with copies of Jackson Co.'s financial statements, which had been audited and certified by E&W, and the Jackson Co.'s interim (*i.e.*, inhouse) financial statements for the four month period ending April 30, 1981. These financial statements

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[2] The failing company doctrine permits failing companies to be considered for acquisition under less stringent anti-trust guidelines than healthy companies.

reflected, *inter alia*, a working capital deficiency, a potential warranty liability problem, a net operating loss of $1,097,427 in 1980, and a net worth of $1,793,203 in 1980.

Mr. DeLuca testified that Mr. Carter explained at the June 17th meeting that the working capital deficiency was due to Jackson Co.'s default under its long-term debt obligations to Citibank.[3] With respect to the potential warranty liability problem, the BWC representatives were advised that the problem involved the product design of pump tanks produced by Medalist Co., Jackson Co.'s subsidiary, but that it had been corrected by a reengineered product design implemented by Medalist Co.

In light of Jackson Co.'s net worth of $1,793,203 in 1980, BWC was convinced that Jackson Co. was a viable company. However, BWC also recognized that Jackson Co.'s continued viability depended upon the cooperation of Citibank and a cure for Jackson Co.'s working capital problem.

Later on June 17, 1981, BWC representative met with Citibank representatives in Atlanta, Georgia, to discuss terms on which Citibank would be willing to continue financing Jackson Co. should BWC acquire the company. There was a suggestion that if BWC did not acquire

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[3] The 1980 financial statements show that $4,108,095 represents "Reclassification of long-term debt in default." Exhibit P-1.

Jackson Co. by Monday, June 22, 1981, Jackson Co. would be liquidated.[4]

II. *The Agreement*

Because of the June 22, 1981 deadline, BWC claims it did not have time to do all of the things normally done in an acquisition of this nature. The only documents provided to BWC which it had an opportunity to review were the 1980 financial statements, and certain documents pertaining to real estate owned by Jackson Co.

On Friday, June 19, 1981, representatives of BWC, the Jackson Co. and Citibank met in a negotiation session which proceeded through the weekend. Late on the evening of Sunday, June 21, 1981, the Agreement between BWC and the Jacksons was executed.

The acquisition of Jackson Co. was accomplished by means of a Stock Purchase Agreement and consulting agreements under which the Jacksons would receive compensation guaranteed by BWC.

The Stock Purchase Agreement provided that the purchase price for the Jacksons' stock, which accounting

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[4] Mr. Richard Lee Cravey, Vice President of Citibank, testified that although it was his concern that if a deal to acquire Jackson Co. was not completed by Monday, June 22, 1981, the company would miss shipments due to a lack of working capital, he did not recall relaying that concern to BWC or advising BWC that the company would be liquidated by June 22. Tr. 7-14-86, A.M. at 56-57.

for 81% of the outstanding stock of the Jackson Co.,[5] would be determined by an audit of the company as of June 30, 1981. The reason for this provision was the parties' lack of confidence in stated net worth because of concern that the inventory shown in the interim financial statements was inaccurate. Under the Agreement, BWC was obligated to pay an amount equal to the stockholders' equity as determined by the June 30, 1981 audit; or if it was less than $600,000, one-half the stockholders' equity plus $600,000 but in no event less than $300,000. This amount was to be paid in three equal annual installments beginning on June 20, 1983 and was to be evidenced by BWC's nonrecourse note to be issued to the Jacksons at a supplemental closing following completion of the June 30, 1981 audit. However, the Agreement permitted BWC the option of returning the stock to the Jacksons "[a]t any time prior to the payment of the first installment of principal [*i.e.*, June 20, 1983] . . . , [thereby] discharg[ing] in full its indebtedness . . . for the purchase price. . . ."

BWC was also obligated to invest $200,000 in Jackson Co. within five business days of the Agreement and to loan not less than $500,000 to Jackson Co. within 60 days of the Agreement. These amounts represent one-half of $1.5 million in new capital which BWC and Citibank agreed was needed to help Jackson Co. recover from its working capital shortage. As an inducement for BWC to enter into the Agreement, Citibank agreed to provide the

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[5] The remaining 19% of the Jackson Co. stock was held by the Jackson Co.

other half of the needed $1.5 million in long-term financing to Jackson Co. and to waive existing defaults under the Jackson Co. loan agreements.

III. *Post-Agreement*

On June 30, 1981, BWC completed its own count of the inventory at Jackson Co. and by the first week of August, 1981, had determined that the value of the inventory was approximately $2.3 million less than the amount indicated on the 1980 statement. At the same time, Jackson Co. was having difficulty satisfying its creditors. BWC considered placing the Jackson Co. into bankruptcy, but instead, BWC guaranteed payments to Jackson Co. creditors and, in effort to avoid further problems with the creditors, organized an informal creditors committee, which met for the first time on August 4, 1981.

On August 31, 1981, E&W issued certified financial statements containing the results of its audit of the Jackson Co. as of June 30, 1981. These statements showed substantial changes in the financial condition of the Jackson Co. as represented by the following categories:

	as of 12-31-80	as of 6-30-81
accounts receivable	$5,243,226	$5,024,697
inventory	$5,917,171	$3,651,604
warranty reserve		
– current	$ 165,000	$ 864,208
– long-term	$ 292,000	$1,372,864
net worth	$1,793,203	($3,606,647)
net income (loss)	($1,097,427)	($5,599,850)

BWC took various measures to compensate for the inventory and warranty problems, including providing

Jackson Co. with materials at the expense of cutting production and laying off employees at BWC's Michigan plant. This was in addition to the infusion of $550,000 in cash to Jackson Co. on August 20, 1981. Nevertheless, by October, 1981, Jackson Co. had lost 60% of its customer base and its financial problems continued. In October, 1981, BWC filed a voluntary petition in bankruptcy on behalf of Jackson Co. seeking protection under Chapter 11 of the Bankruptcy Code.

BWC claims that it was contractually obligated to loan $550,000 to Jackson Co. in August, 1981 regardless of whether it exercised its right to return the stock to the Jacksons. Further, BWC felt an obligation to Citibank to loan the money to Jackson Co. since Citibank agreed to stand still and extend financing to Jackson Co. for 90 days on the basis that BWC was going through with the transaction.

On November 6, 1981, in accordance with the terms of the Agreement, BWC delivered to the Jacksons a non-recourse promissory note in the amount of $300,000 representing the purchase price for the outstanding stock of the Jackson Co. based on a negative net worth of $3.6 million as of June 30, 1981. Exhibit D-14. In November, 1981, interest rates had risen to record highs and a housing slump, which had been adversely affecting water heater sales, was contributing to Jackson Co.'s decline.

In February, 1982, BWC liquidated the Medalist Co. Finally, in April, 1982, BWC was forced to liquidate Jackson Co. On June 14, 1982, the Jacksons sued on BWC's guarantee of the consulting fees. BWC subsequently paid $250,000 to the Jacksons in settlement of that dispute.

On July 14, 1983, BWC filed this action against E&W, alleging that in connection with the sale of securities by the Jacksons to BWC, E&W knowingly misrepresented or withheld material facts concerning the financial condition and business capability of the Jackson Co. subsequent to the issuance of the 1980 financial statements.

IV. Answers to Special Interrogatories

Eleven special interrogatories were submitted to the jury at the close of the case. The responses to the special interrogatories[6] show that the jury found for E&W on the pendent state law claims but held for BWC on the 10b-5 claim.

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[6] The special interrogatories and the jury's responses thereto are as follows:

1. Do you find by a preponderance of the evidence that Defendant Ernst & Whinney, in connection with its audit or opinion concerning the December 31, 1980 consolidated financial statements of the W. L. Jackson Manufacturing Company, made a material misrepresentation or a material omission with respect to any of the following:

(a)	Inventory	Yes	✓	No ___
(b)	Accounts Receivable	Yes	___	No ✓
(c)	Product Warranty Liability	Yes	✓	No ___
(d)	Net Worth	Yes	✓	No ___
(e)	Net Income (Loss)	Yes	✓	No ___

(Continued on following page)

With respect to the 10b-5 claim in response to special interrogatories, the jury found that E&W had made

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(Continued from previous page)

(f) That Ernst & Whinney conducted its audit in accordance with generally accepted auditing standards — Yes ✓ No ___

(g) That the financial statements taken as a whole as qualified by the opinion of Ernst & Whinney presented fairly the financial position of the W. L. Jackson Manufacturing Company in accordance with generally accepted accounting principles — Yes ___ No ✓

If you have answered "yes" to one or more of the above, proceed to question #2. If you have answered "no" to each of the above, proceed directly to question #6.

2. Do you find by a preponderance of the evidence that any of the representations or omissions were made *either* (1) with *knowledge* that the statement was false or misleading, or (2) with reckless indifference as to whether or not it was true?

Yes ✓ No ___

If your answer is "yes" please identify by letter the particular item or items: c, f

and then proceed to question #3.

If your answer is "no" as to each item, proceed to question #6.

3. With regard to those items identified in your response to question #2, do you find by a preponderance of the evidence

(Continued on following page)

material misrepresentations in five out of seven categories but that only two were made with knowledge that the statements were false or with reckless indifference as

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(Continued from previous page)

that Bradford-White (1) relied on the false statement or misleading omission in deciding to buy the stock of the W. L. Jackson Company, and (2) that it was reasonable to so rely?

Yes ✓ No ___

If your answer is "yes" identify by the letter used above which item or items:

and then proceed to question #4.

If your answer is "no" as to each item, proceed directly to question #6.

4. Were the representations by Ernst & Whinney made without any reasonable ground for believing it to be true and with the intent to induce others to rely upon it?

Yes ✓ No ___

Proceed to question #5.

5. Were the representations by Ernst & Whinney made with the intent to defraud others?

Yes ___ No ✓

Proceed to question #6.

6. Do you find by a preponderance of the evidence that Ernst & Whinney failed to use the care and skill ordinarily used in like cases by reputable members of the accounting profession practicing in the same or a similar locality, under similar circumstances?

Yes ✓ No ___

(Continued on following page)

to whether they were true. Of those two, the jury found that BWC reasonably relied on one *viz.*, that E&W conducted its audit in accordance with generally accepted

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(Continued from previous page)

If your answer is "yes" proceed to question #7.

If your answer is "no" and you have answered "no" to questions #1, #2 *or* #3, do not proceed any further.

If your answer is "no" and if you have answered "yes" to questions #1, #2 *and* #3, go directly to question #10.

7. Did Ernst & Whinney's failure as described in question #6, lead to a material misrepresentation or a material omission upon which Bradford-White relied?

Yes ✓ No ___

If your answer is "yes" proceed to question #8.

If your answer is "no" and you have answered "no" to questions #1, #2 *or* #3, do not proceed any further.

If your answer is "no" and if you have answered "yes" to questions #1, #2 *and* #3, then proceed to question #10.

8. Was Bradford-White contributorily negligent?

Yes ✓ No ___

If you have answered "yes" proceed to question #9.

If your answer is "no" proceed directly to question #10.

9. Do you find that Bradford-White's negligence is too far removed as to time or place or causative force to be a direct or proximate cause of the injury?

Yes ___ No ✓

(Continued on following page)

auditing standards ("GAAS").[7] With respect to the pendent state law claims, in response to special interrogatories based on Tennessee law, the jury found that E&W made material misrepresentations without any reasonable ground for believing them to be true and with intent to induce others to rely upon them (*i.e.*, negligent misrepresentation;[8] made such misrepresentations without intent

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(Continued from previous page)

If your answer is "yes" proceed to question #10.

If your answer is "no" and you have answered "no" to questions #1, #2 *or* #3, do not proceed further.

If you have answered "yes" to questions #1, #2 *and* #3, proceed to question #10.

10. In what amount do you award damages?

$ 1,242,151

Proceed to question #11 only if you have answered "yes" to question #9.

11. State the amount by which the damages should be reduced to reflect Bradford-White's proportional contribution to the damages.

$ _____

[7] Special Interrogatory Answers 1, 2 and 3. *See Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981); *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979).

[8] Special Interrogatory Answer 4. *See Jasper Aviation, Inc. v. McCollum Aviation, Inc.*, 497 S.W.2d 240 (Tenn. 1972);*Tartera v. Palumbo*, 224 Tenn. 262, 453 S.W.2d 780 (1970); *McElroy v. Boise Cascade Corporation*, 632 S.W.2d 127 (Tenn. App. 1982).

to defraud others (*i.e.*, intentional misrepresentation);[9] and failed to use the care and skill ordinarily used in like cases by reputable members of the accounting profession practicing in the same or similar locality, under similar circumstances, and that this failure resulted in E&W making such misrepresentations upon which BWC relied (*i.e.*, professional malpractice).[10] The jury determined, however, that BWC was contributory negligent and such negligence was a direct or proximate cause of its injury.[11] Thus, the jury found in favor of E&W on the intentional misrepresentation claim, and under Tennessee law, contributory negligence is a complete defense to negligent misrepresentation and professional malpractice claims. *See Arnold v. Hayslett*, 655 S.W.2d 941 (Tenn. 1983); *Street v. Calvert*, 541 S.W.2d 576 (Tenn. 1976); *McElroy v. Boise Cascade Corporation*, 632 S.W.2d 127 (Tenn. App. 1982).

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[9] Special Interrogatory Answer 5. *See Edwards v. Travelers Insurance of Hartford, Connecticut*, 563 F.2d 105 (6th Cir. 1977); *Shell Oil Co. v. State Tire & Oil Co.*, 126 F.2d 971 (6th Cir. 1942); *Jasper Aviation, Inc.*, 497 S.W.2d 240 (Tenn.); *McElroy*, 632 S.W.2d 127 (Tenn. App.); *Southern States Development Company, Inc. v. Robinson*, 494 S.W.2d 777 (Tenn. App. 1972).

[10] Special Interrogatory Answers 6 and 7. *See Wharton Transport Corporation v. Bridges*, 606 S.W.2d 521 (Tenn. 1980); *Tartera*, 224 Tenn. 262, 453 S.W.2d 780; *Delmar Vineyard v. Timmons*, 486 S.W.2d 914 (Tenn. App. 1972).

[11] Special Interrogatory Answers 8 and 9. *See Arnold v. Hayslett*, 655 S.W.2d 941 (Tenn. 1983); *Street v. Calvert*, 541 S.W.2d 576 (Tenn. 1976); *McElroy*, 632 S.W.2d 127 (Tenn. App.).

DISCUSSION

E&W argues that the jury's responses to the special interrogatories require that its motion to amend the judgment in its favor on all counts be granted. Specifically, E&W claims that BWC is precluded from recovery under its 10b-5 claim because the jury determined, as reflected in their responses to the special interrogatories, that (1) E&W merely failed to disclose its auditor's negligence in conducting the audit of the Jackson Co.; (2) there was no relied-on misstatement, made with scienter, touching upon the value of the Jackson Co. stock; (3) BWC failed to exercise due diligence in acquiring the Jackson Co.; and (4) the 1980 financial statements comported with generally accepted accounting principles ("GAAP"). Also, E&W contends that the jury specifically rejected BWC's pendent state law claims as shown by their responses to special interrogatories 4, 5, 6, 7, 8 and 9.

E&W makes the same argument in support of its motion for judgment notwithstanding the verdict on all counts. Further, as to the 10b-5 and intentional misrepresentation claims, E&W argues that it is entitled to judgment notwithstanding the verdict because the evidence "was too attenuated to provide the jury with a rational basis" on which to find scienter. *Brief in Support of E&W's Motion for Judgment Notwithstanding the Verdict or for New Trial* at 7.

In the alternative, E&W moves for a new trial on all counts for which judgment is not entered in this favor on grounds that (1) the evidence shows that E&W's conduct was not the proximate cause of BWC's loss; (2) the jury's findings, if interpreted so as to deny the relief sought by

E&W in the above-mentioned motions, are inconsistent; and (3) the court erred in failing to give or adequately cover E&W's proposed jury instructions and in giving other instructions to which E&W objected.

In addition, E&W now argues for the first time that BWC's 10b-5 claim is barred by the applicable statute of limitations. *Supplemental Memorandum of Law in Support of E&W's Motion for New Trial.*

For the reasons set forth below, E&W's motion to amend the judgment in its favor as to the pendent state law claims and its motion for new trial on the 10b-5 claim will be granted. All others motions will be denied.

I. *Statute of Limitations*

Citing *Friedlander v. Troutman, Sanders, Lockerman & Ashmore,* 788 F.2d 1500 (11th Cir. 1986), E&W argues that BWC's 10b-5 claim is barred by the statute of limitations.

I am not persuaded that E&W has timely raised the statute of limitations issue. First, *Friedlander* is not new controlling law in this circuit. *Philadelphia World Hockey Club, Inc. v. Philadelphia Hockey Club, Inc.,* 351 F. Supp. 457, 461 (E.D. Pa. 1972). Second, *Friedlander* was decided on May 9, 1986 and was reported in the advance sheets of the Federal Reporter on June 4, 1986, more than a month before the date on which this trial commenced July 7, 1986, and more than 2 months before E&W filed its post-trial motions. Unlike the situation in *Perrine v. Montone,* 76 F.R.D. 444, 451 (E.D. Pa. 1976), cited by E&W as supporting its position that the statute of limitations issue is preserved, E&W presents a new issue, not raised at trial, premised on a noncontrolling decision which was

reported prior to trial. Therefore, I find that the statute of limitations issue is not preserved and is deemed to have been waived. *See* Fed. R. Civ. P. 8(c); 12(b)(6) and 12(h)(2); and 51. *See also Barby v. Cabot Corporation*, 598 F. Supp. 407, 414 (W.D. Okla. 1983).

II. *Governing Law*

Federal courts are required to apply the conflict of law rules of the state in which they are sitting. *Klaxon Co. v. Stentor Electric Manufacturing Co., Inc.*, 313 U.S. 487, 61 S. Ct. 1020, 85 L.Ed.2d 1477 (1941). Thus, Pennsylvania's conflicts rules must be utilized in choosing between Pennsylvania and Tennessee law.

Pennsylvania applies a flexible conflicts analysis in tort actions which "takes into account both the grouping of [significant] contacts with the various concerned jurisdictions and the interests and policies that may be validly asserted by each jurisdiction." *Melville v. American Home Assurance Company*, 584 F.2d 1306, 1311 (3d Cir. 1978) (citing *Griffith v. United Air Lines, Inc.*, 416 Pa. 1, 203 A.2d 796 (1964)).

BWC contends that Pennsylvania has the most significant contacts with the parties and the subject transactions since the negotiations leading to BWC's purchase of Jackson Co. occurred in Philadelphia and Philadelphia is BWC's principal place of business and hub of its financial operations. Further, BWC claims that since Philadelphia is BWC's principal place of business, BWC's loss of profits and income occurred in Pennsylvania. *See B.J. McAdams, Inc. v. Boggs*, 426 F. Supp. 1091, 1097 n.5 (E.D. Pa. 1977) (the locus of the tort is "the place where a loss of profits or income is registered"). Thus BWC argues

that "Pennsylvania, as the home state of the injured party, also had the greatest interest in the outcome of this litigation." *Memorandum of Law in Support of Plaintiff BWC's Conditional Motion for New Trial* at 6.

While Pennsylvania is not a disinterested forum in this case, I conclude that Tennessee has the most significant contacts with the parties and the relevant transactions, as well as the greater interest in the outcome of this action. First, Tennessee was the place where the E&W audit was performed, where the E&W opinion letter was written and delivered, where the Jackson Co. was located, where BWC operated the Jackson Co., and where the Jackson Co. went bankrupt and was liquidated. These contacts are more significant than the above-mentioned Pennsylvania contacts, especially considering the fact the fact that E&W was not invited to the negotiations in Philadelphia and neither appeared nor participated in those negotiations. Second, the interest which Tennessee has in regulating the conduct of Tennessee accountants outweighs Pennsylvania's interest in providing a remedy to a Tennessee corporation such as BWC, which allegedly incurred damages in acquiring and operating another Tennessee corporation. I, therefore, hold that this court's decision to apply Tennessee law to the pendent claims was correct.

III. *The Pendent State Claims*

E&W moves that the judgment be amended to read in its favor as to the pendent state law claims, in accordance with the jury's responses to special interrogatories 4, 5, 6, 7, 8 and 9. BWC argues that E&W's motion should be

denied and, in the event this court disturbs the judgment or orders a new trial as to any issues herein, a new trial should be awarded because the jury's responses to the special interrogatories are both incomplete and inconsistent due to the court's errors in phrasing the special interrogatories and in charging the jury. *Plaintiff BWC's Conditional Motion for New Trial; Memorandum of Law in Support of Plaintiff BWC's Conditional Motion for New Trial.*

The jury's responses to special interrogatories 4, 5, 6, 7, 8, and 9 warrant an award for E&W on the pendent state claims. Accordingly, I will consider BWC's conditional motion for new trial as to these claims.

BWC asserts that the court erred in phrasing special interrogatory 5 relative to intentional misrepresentation and in subsequently explaining the state of mind required for such cause of action. Consequently, BWC contends, the jury was caused to give answers to special interrogatories 2 (relative to the state of mind required for the 10b-5 claim) and 5 which are inconsistent and contrary to law.

BWC also argues that the court erred in charging the jury on gross negligence and in subsequently failing to submit a special interrogatory on gross negligence. This, according to BWC, resulted in responses to special interrogatories 8 (that BWC was contributory negligent) and 9 (that BWC's negligence was the direct or proximate cause of its injury) which bar BWC's recovery on its claims for negligent misrepresentation and professional malpractice. BWC claims that such a result is contrary to law and the evidence presented at trail.

As to the intentional misrepresentation claim, the jury was instructed that plaintiff must show:

> 1. [t]he defendant . . . made a representative as to a past or existing material fact; 2. [t]he representation [was] false; 3. *[t]he defendant knew that the representation was false when he made it [or he . . . made the representation recklessly without knowing whether it was true or false]*; 4. [t]he defendant . . . made the representation with an *intent to defraud* the plaintiff, that is, he . . . made the representation *for the purpose of inducing* the plaintiff to rely upon it and to act or to refrain from acting in reliance thereon; 5. [t]he plaintiff [was] unaware of the falsity of the representation; he . . . acted in reliance upon the truth of the representation and he [was] justified in relying upon the representation; . . . and 6. . . . as a result [of] his reliance upon the truth of the representation, the plaintiff sustained damage.

Tennessee Pattern Jury Instructions - Civil 8.41 (West Supp. 1985) (emphasis added). *See also Edwards v. Travelers Insurance of Hartford, Connecticut*, 563 F.2d 105 (6th Cir. 1977); *Jasper Aviation, Inc. v. McCollum Aviation, Inc.*, 497 S.W.2d 240 (Tenn. 1972); *Tartera v. Palumbo*, 224 Tenn. 262, 453 S.W.2d 780 (1970). BWC correctly points out that the third element of this instruction relates to scienter or state of mind and that the forth element pertains to causation. BWC claims, however, that the jury was twice misguided by the court as to the law of intentional misrepresentation. First, BWC argues that the court erred in its response to a jury question, raised at the time of the jury's deliberations, as to whether special interrogatories 1-5 pertained to the 10b-5 claim. The court explained that special interrogatories 1-3 related to the 10b-5 claim and

that special interrogatories 4 and 5 related to the state of mind required under the state of law claims. BWC argues that this explanation may have misled the jury to believe that the state of mind necessary to establish intentional misrepresentation could only be satisfied by proof of "intent to defraud," relating to causation (not scienter) under the fourth element of the intentional misrepresentation instruction, and could not be satisfied by recklessness. I disagree. The jury was charged prior to commencing deliberations that recklessness suffices to establish scienter. Therefore, I find that the jury was properly instructed.

The second error cited by BWC with respect to the intentional misrepresentation claims concerns the court's instruction attempting to distinguish the causation requirements for negligent and intentional misrepresentation. The court instructed that intentional misrepresentation requires an "intent to defraud" while negligent misrepresentation requires only an "intent to induce." Tr. 7-25-86, A.M. at 37-38, lines 24-25; 1-4. BWC claims that since the fourth element of the court's earlier instruction on intentional misrepresentation describes "intent to defraud" as being equivalent to "for the purpose of inducing," the causation elements for intentional and negligent misrepresentation are similar. BWC therefore argues that the court's attempt to distinguish these causes of action served only to confuse the jury, warranting a new trial on the state claims should the present judgment be disturbed. I reject BWC's argument as I find that the instruction distinguishing the causation requirements was a correct statement of Tennessee law.

Furthermore, I detect no confusion or inconsistency in the jury's responses to special interrogatories 2 (10-5 - scienter) and 5 (intentional misrepresentation - scienter). Based on the evidence, the jury could have reasonably concluded the BWC did not sustain its burden of proof as to its claim for intentional misrepresentation.

I also reject BWC's assertion that the court erred in instructing the jury in the area of gross negligence and in failing to submit a special interrogatory on gross negligence. The source of the instruction on gross negligence was the Tennessee Pattern Instruction - Civil 3.51, to which BWC neither objected at trial nor submitted an alternative charge. BWC also failed to submit its own proposed special interrogatory on this issue and did not object to the special interrogatories used by the court. Consequently, BWC is deemed to have waived these alleged errors.

BWC further claims that it is entitled to a new trial on the pendent state claim for professional malpractice because the court erred in failing to instruct the jury on an auditor's duty of care as enunciated in *United States v. Arthur Young & Company*, 465 U.S. 805, 104 S. Ct. 1495, 79 L.Ed. 2d 826 (1984).

In *Arthur Young*, the Court rejected Arthur Young's contention that an accountant's tax accrual work papers were subject to an accountant-client privilege. 456 U.S. at 817-19, 104 S. Ct. at 1502-04, 79 L.Ed.3d at 836-37. In so holding, the Court stated that "the independent certified public accountant cannot be content with [its client's] representations that its tax accrual reserves are adequate; the auditor is ethically and professionally obligated to

ascertain for himself as far as possible whether the [client's] contingent tax liabilities have been accurately stated." *Id.* at 818, 104 S. Ct. at 1503, 79 L.Ed.2d at 836. Based on this language, BWC requested the following instruction:

> . . . [T]he fact that [E&W's] client, the Jackson [Co.], may have committed a fraud did not relieve [E&W] from its obligations to independently examine, investigate and determine the true financial condition of the Jackson [Co.] In short, the fraud of the Jackson [Co.] is not a defense to the claim asserted by [BWC] against [E&W].

BWC's Proposed Jury Instruction 12.

The proposed instruction was rejected by the court as not necessary (Tr. 7-25-86, A.M. at 50) since the jury would be charged with respect to an accountant's standard of care. *See* Tr. 7-25-86, A.M. at 33. Upon further consideration, I conclude that the proposed instruction, insofar as it states that fraud by the Jackson Co. is not a defense to the professional malpractice claim, is contrary to the law. While an accountant's duty of care requires that he "ascertain for himself *as far as possible*" whether the client's records are accurate, *Arthur Young*, 465 U.S. at 818, 104 S. Ct. at 1503, 79 L.Ed.2d at 836 (emphasis added), the accountant is not obliged to uncover its client's fraud or to guarantee its client's records. *See McLean v. Alexander*, 599 F.2d 1190, 1202 (3d Cir. 1979). Thus, the alleged fraud of the Jackson Co. may serve as a defense to BWC's negligence and professional malpractice claims only if E&W followed applicable standards to ascertain the genuineness of the Jackson Co.'s records and representations.

Accordingly, a judgment will be entered in favor of E&W on the pendent state claims.

IV. *The 10-5 Claim*

It is E&W's contention that the judgment should be entered in its favor on the 10b-5 claim because BWC's losses resulted from BWC's mismanagement and not from reliance upon Jackson Co. financial statements. I am satisfied that there is sufficient evidence to support a 10b-5 claim. *See Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472-74, 97 S. Ct. 1292, 1300-01, 51 L.Ed.2d 480, 491-92 (1977); *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979).

In order to establish a 10b-5 claim against E&W, BWC must prove by a preponderance of the evidence that E&W made misstatements or omissions of material fact, with scienter, upon which it relied and which proximately caused its injury. *McLean*, 599 F.2d 1190.

The jury found that E&W materially misrepresented that it conducted its audit in accordance with generally accepted auditing standards ("GAAS") (special interrogatory answer 1 (f)); that such misrepresentation was made by E&W with scienter (special interrogatory answer 2); and that BWC reasonably relied on that misrepresentation (special interrogatory answer 3). There was ample evidence to support these findings.[12] In support of its

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[12] In its motion for judgment notwithstanding the verdict, E&W does not attack the jury's finding that the audit was not conducted in accordance with GAAS. The record, however, is clear the E&W accepted without verification information supplied by Jackson Co. Management.

motions to amend the judgment and for judgment notwithstanding the verdict or for new trial, E&W argues that judgment should be awarded in its favor or a new trial should be awarded on the 10b-5 claim because the clear weight of the evidence shows that the non-GAAS audit is not causally connected to BWC's losses. Rather, E&W contends, the real cause of Jackson Co.'s demise and, consequently, BWC's losses was the recession in 1981-82 and the decline in housing starts over the period. Evidence such as a BWC news release (Exhibit D-16) and a BWC newsletter (Exhibit D-15), both written subsequent to the closing of Jackson Co. in April, 1982 and in which Mr. DeLuca of DWC is quoted as having said that the housing recession contributed to Jackson Co's closing, are claimed to be admissions of an intervening cause of BWC's losses. Also, E&W claims that Mr. DeLuca admitted that E&W warned him prior to the Agreement that a housing recession could affect the achievement of a profitable operation (Tr. 7-9-86, P.M. at 68) and that he was relying on his own judgment as to "whether or not there would be a housing recession . . . " (Tr. 7-9-86, P.M. at 75). Further, E&W argues that any misstatement about the conformity of the Jackson Co. audit with GAAS did not misrepresent the value of the Jackson Co. portrayed by the 1980 financial statements.

E&W's argument raises an issue of proximate cause or loss causation, as distinguished from transaction causation which the parties agree is not in dispute.[13]

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[13] The following elements must be established to prove causation in 10b-5 cases:

(Continued on following page)

The Fifth Circuit has explained loss causation in a 10b-5 action as follows:

> The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition *that the untruth was in some reasonably direct, or proximate, way responsible for his loss.* The causation requirement is satisfied in a Rule 10b-5 case *only if the misrepresentation touches upon the reasons for the investment's decline in value.* If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted.

Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375, 103 S. Ct. 683, 74 L.Ed.2d 548 (1983) (citations omitted) (emphasis added).

E&W relies heavily on *In re Catanella and E. F. Hutton and Company, Inc. Securities Litigation*, 583 F. Supp. 1388

(Continued from previous page)

(1) a relationship must exist between the alleged fraudulent misrepresentation or omission and the purchase or sale of a security;

(2) the violations in question must have induced the plaintiff to purchase the security (*i.e.*, transaction causation); and

(3) the misrepresentation or omission must have caused the plaintiff's pecuniary loss (*i.e.*, loss causation).

In re Catanella and E. F. Hutton and Company, Inc. Securities Litigation, 583 F. Supp. 1388, 1414 (E.D. Pa. 1984). *See also Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976, 95 S. Ct. 1976, 44 L.Ed.2d 467 (1975). In this action, the parties do not dispute that the first and second elements are satisfied.

(E.D. Pa. 1984), in which the court applied the Fifth Circuit's definition of loss causation in dismissing a 10b-5 claim. In *Catanella*, plaintiffs sued E.F. Hutton and Co. and Catanella, a securities broker employed by E. F. Hutton, for losses they incurred in the securities market. The claims against Catanella included churning, failure to disclose the risks of option and margin trading, and the purchase of unsuitable securities. Catanella also failed to disclose that as a defendant in another lawsuit he was found to have committed various acts of securities fraud. Plaintiffs in *Catanella* attempted to link Catanella's failure to disclose the prior litigation against him to their losses, claiming "that had they known about Catanella's involvement, they would not have dealt with him or given him broad discretion over their accounts." 583 F. Supp. at 1413. The court found Catanella's failure to inform the plaintiffs of the risks with regard to margin trading and Catanella's churning of their accounts to be the proximate causes of plaintiffs' losses and rejected as a cause of plaintiffs' losses Catanella's failure to disclose the prior litigation. *Id.* at 1416-17.

BWC contends that despite the effect the housing market had on Jackson Co.'s downfall, it relied on E&W's certified GAAS opinion as to the financial position of the Jackson Co. The record reflects that the 1980 financial statements were central to negotiations and that representations contained in those financial statements were the basis for certain provisions in the Agreement.

BWC also argues that had a GAAS audit been conducted, E&W would have uncovered material information as to inventory, product warranty liability, net worth and net income, all of which the jury concluded were

materially misstated in the 1980 financial statements. I agree. The misstatements which resulted from the non-GAAS audit caused BWC to be without knowledge of the true risks inherent in the purchase of the Jackson Co. There was testimony that the inventory category was not adjusted for obsolete materials and that a lack of adequate materials caused Jackson Co. to miss customer deliveries. The testimony also showed that Jackson Co. lost 60% of its customers by October, 1981 due to missed deliveries. This resulted in a decline in revenue and led to Jackson Co.'s inability to satisfy its creditors. When creditors eventually cut off supplies to Jackson Co., BWC had no choice but to put the company into liquidation.

This case is distinguishable from *Catanella*. Here, BWC was aware at the time of the Agreement that a housing recession might bring difficult times to Jackson Co. BWC was not prepared, however, to withstand losses brought on by Jackson Co.'s inventory and materials shortages, which it discovered subsequent to the Agreement. The evidence would support a finding that E&W's failure to follow GAAS caused BWC not to be adequately informed on the true state of affairs at Jackson Co. Thus, the jury could reasonably conclude that unlike Catanella's failure to disclose the prior litigation against him, the non-GAAS audit was connected to Jackson Co.'s demise and BWC's losses.

Next, I reject E&W's contention that the jury's response to special interrogatories 8 and 9, that BWC was contributorily negligent and that such negligence was the direct or proximate cause of its injury, also entitles it to judgment on the 10b-5 claim.

Contributory negligence is not a defense to a 10b-5 claim. Rather, a 10b-5 claim can be refuted by a lack of due diligence by the plaintiff. *Straub v. Vaisman & Co., Inc*, 540 F.2d 591, 598 (3d Cir. 1976). Due diligence requires that the plaintiff have acted reasonably under the circumstances. *Id.* at 598. "Since the failure to meet the standard is in the nature of an affirmative defense, the burden of proof rests upon the defendant. Such matters as fiduciary relationship, opportunity to detect the fraud, sophistication of the plaintiff, the existence of long standing business or personal relationships, and access to the relevant information are all worthy of consideration. *Id.* (footnote omitted).

The issue of due diligence was not submitted to the jury because E&W did not sustain its burden of proof. The evidence shows that BWC was not in a position to investigate the procedures followed in conducting the audit and in reporting the financial information. There is no dispute that BWC had a very limited opportunity to investigate the Jackson Co. due to the time constraints. Further, BWC relied on the professional standing of E&W, a big eight accounting firm, in accepting the information contained in the 1980 financial statements. Though a sophisticated investor, BWC "was not barred by reliance upon the honesty [of E&W] in the absence of knowledge that the trust [was] misplaced." *Straub*, 540 F.2d at 598. In the absence of evidence that BWC had such knowledge at the time of the Agreement, the due diligence defense was properly rejected.

E&W also argues that its motion for judgment notwithstanding the verdict should be granted with regard to its 10b-5 claim because the evidence is undisputed that

BWC relied on its own business judgment regarding Jackson Co.'s possible profitability, thus breaking the chain of causation, if any, between E&W's misstatement of a GAAS audit and BWC's losses.

There is sufficient evidence in the record from which the jury could reasonably conclude that BWC's actions subsequent to its discovery of the true state of affairs were not speculative and do not negate BWC's initial reliance on E&W's audit of the Jackson Co. BWC's counsel testified that BWC delayed filing suit in the hope that the losses might be curtailed. This was not a case where the purchased securities increased in value after the purchaser became aware that he had been defrauded. In that situation, a purchaser who chooses to speculate and then sue in the event he incurs a loss will be found to have waived his claim. *See Royal Air Properties, Inc. v. Smith,* 312 F.2d 210, 213-14 (9th Cir. 1962); *Jaksich v. Thomson McKinnon Securities, Inc.,* 582 F. Supp. 485, 496-98 (S.D.N.Y 1984). I do not think it can be disputed that BWC knew it was purchasing a troubled company, but the misleading financial statements masked the depth of the troubles and the irretrievability of the situation. The testimony of Mr. DeLuca and Mr. Middleton fairly establishes BWC's reliance on the misstatements in the 1980 financial statements at the time of the Agreement. The record reflects that by the time BWC discovered the fraud in July, 1981, it had already invested $200,000, had its own employees operating the Chattanooga plant, had used BWC invoices to purchase materials for Jackson Co., had purchased Jackson Co. water heaters and sold BWC water heaters to Jackson Co. in an effort to improve the volume and alleviate inventory shortages, had taken

measures to correct the warranty problems of the Jackson Co.'s subsidiary, had begun redesigning Jackson Co. water heaters and retooling in order to make the manufacturing process at Jackson Co. more efficient, and had made promises to Jackson Co. trade creditors and customers. There was evidence the BWC felt a moral obligation to Citibank to make every effort possible towards making Jackson Co. a successful company, including investing another $550,000. Also, the testimony shows that BWC understood that it was contractually bound to pay the Jacksons under the consulting agreements despite the discovery of E&W's misrepresentations. Once BWC made these commitments it is not reasonable to suggest that it turn its back and walk away from the deal. The damage had been done. Thus, E&W's motion for judgment notwithstanding the verdict on causation grounds will be denied.

E&W also argues in support of its motion for judgment notwithstanding the verdict on the 10b-5 claim that the evidence does not establish a reasonable basis on which to find scienter. According to E&W, the evidence shows that, at the time of the audit, it was defrauded by Jackson Co. and that it did not know that its audit did not comport with GAAS. There was testimony that Jackson Co. employees purposely kept pertinent documents from being discovered by E&W's auditors and that E&W's work papers reflect statement made and documents supplied by management which were accepted by E&W without verification.

The Third Circuit has said that "[a] showing of shoddy accounting practices amounting at best to a 'pretended audit,' or of grounds supporting a representation

'so flimsy as to lead to the conclusion that there was no genuine belief back of it' have traditionally supported a finding of liability in the face of repeated assertions of good faith, and continue to do so." *McLean v. Alexander*, 599 F.2d 1190, 1198 (3d Cir. 1979) (footnotes omitted). The record clearly supports an inference that when E&W stated that its audit was in accordance with GAAS, E&W "had no genuine belief that it had the information on which it could predicate that opinion." *Id.* at 1198.

Despite the misrepresentations found by the jury, the jury also determined that "the [1980] financial statements taken as a whole as qualified by the opinion of [E&W] presented fairly the financial position of the [Jackson Co.] in accordance with generally accepted accounting principles." Special Interrogatory Answer 1(g). E&W contends that this finding means that the jury "appreciated the effect of E&W's qualifications" as to the category of product warranty liability contained in the 1980 financial statements[14] and "found that any misstatement respecting inventory, net worth, or net income was not sufficiently *material* to prevent the financial statements from

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[14] E&W's opinion letter attached to the 1980 financial statements provides that, in 1980, Jackson Co. "experienced a substantial increase in the return of units sold under warranty" and that therefore E&W was "unable to reach a conclusion as to the reasonableness of the product warranty liability as stated." Exhibit P-1. There was testimony, however, that the figure contained under product warranty liability in the 1980 financial statements did not cover warranties issued by Medalist Co., Jackson Co.'s subsidiary, and that in conducting the audit, E&W discovered a serious warranty problem at Medalist Co. but failed to disclose the problem in its opinion letter. Tr. 7-11-86, A.M. at 43, 45, 47-48.

fairly presenting Jackson [Co.'s] condition 'as a whole.'" *Brief in Support of E&W's Motion to Amend the Judgment* at 9. Thus, E&W contends that the answer to special interrogatory 1(g) shows that the financial statements were not misleading and compels that judgment be awarded in its favor. E&W's argument requires this court to weigh the materiality of the misrepresentations. The weighing of the evidence is the exclusive responsibility of the jury. Therefore, I will deny E&W's motion to amend the judgment on the basis of the jury's response to special interrogatory 1(g).

However, I agree with E&W that the jury's response to special interrogatory 1(g), that "the [1980] financial statements taken as a whole as qualified by the opinion of [E&W] presented fairly the financial position of the [Jackson Co.] in accordance with generally accepted accounting principles," contradicts the jury's findings that the financial statements contained material misrepresentations as to the audit having been conducted in accordance with GAAS (Special Interrogatory Answer 1(f)) and as to the inventory, product warranty liability, net worth, and net income categories (Special Interrogatory Answers 1(a), 1(c), 1(d) and 1(e), respectively). BWC all but conceded this contradiction at oral argument but argued that the response to special interrogatory 1(g) should not affect the judgment in its favor because the jury found, as a basis for liability, that E&W made a material misrepresentation with scienter (that the audit was conducted in accordance with GAAS) upon which BWC relied and determined that BWC suffered $1,242,151 in damages as a result of their reliance of that misrepresentation. Thus, BWC claims that it is clear that the jury intended to

award a verdict in favor of BWC despite their response to special interrogatory 1(g). I would agree if the response to special interrogatory 1(g) could be reconciled with the jury's findings that the financial statements contained material misrepresentations. I am unable to reconcile the undisputed contradiction in the answers to the special interrogatories, and accordingly, a new trial is warranted with respect to the 10b-5 claim.

In its conditional motion for new trial, BWC argues that if a new trial is warranted it must be granted as to both the federal and state claims since they have elements in common and are, therefore, inseparable. As discussed above, the jury's responses to the special interrogatories show that they specifically rejected BWC's state claims. The jury's findings with respect to BWC's federal claim in no way contradict their conclusions as to the state claims, and the issues pertaining to the federal claim are distinct from those relating to the state claims. Therefore I will deny BWC's conditional motion for a new trial and grant E&W's motion for a new trial as to the 10b-5 claim only.[15]

An appropriate Order follows.

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[15] The remaining arguments of the parties relating to the jury charge as to damages will not be considered in light of the award of a new trial. For this reason, BWC's claim in its conditional motion for new trail that the court erred in failing to instruct the jury as to aider and abettor liability will also not be considered.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

BRADFORD-WHITE CORPORATION	:	CIVIL ACTION
v.	:	
ERNST & WHINNEY	:	NO. 83-3371

ORDER

AND NOW this 20th day of November, 1987, upon consideration of Bradford-White Corporation's motion for reconsideration of this Court's Order of August 25, 1987, or, in the alternative, for certification of the Court's Order for Interlocutory Appeal, and Ernst, & Whinney's response thereto, it is hereby

ORDERED that the motion be and the same hereby is DENIED. This ruling is based upon the substance of the motion and not on procedural grounds.

/s/ Joseph L. McGlynn, Jr.
Joseph L. McGlynn, Jr.
UNITED STATES DISTRICT JUDGE

ENTERED: 11/24/87
CLERK OF COURT

FILED NOV 24 1987

OPINION LETTER OF ERNST & WHINNEY

ERNST & WHINNEY
400 Volunteer Building
Chattanooga, Tennessee 37402
615/756-2461

Board of Directors
W. L. Jackson Manufacturing Company
Chattanooga, Tennessee

We have examined the consolidated balance sheets of W.L. Jackson Manufacturing company and subsidiaries as of December 31, 1980 and 1979, and the related consolidated statements of income and retained earnings and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

During 1980 the Company experienced a substantial increase in the return of units sold under warranty. Because of the significant effect of this change in experience we were unable to reach a conclusion as to the reasonableness of the product warranty liability as stated.

During 1980 and 1979, the Company incurred net losses of $1,097,427 and $154,997, respectively. These losses significantly weakened the Company's financial condition which resulted in the violation of certain loan covenants during 1980. These violations permit the acceleration of the term loan and obligations under the revolving credit agreement described in Note C. Future working capital availability is dependent on the Company's ability to

restore and maintain profitable operations, to restructure its financing arrangements and to obtain additional financing as required. Because the achievement of profitable operations is dependent on future events, there can be no assurance that the existing financing arrangements will continue or be restructured or whether additional financing can be arranged, if needed. The accompanying financial statements have been prepared on the basis of accounting principles applicable to a going concern and, accordingly, they do not purport to give effect to adjustments, if any, that may be appropriate should the Company be unable to continue as a going concern and therefore be required to realize its asserts and liquidate its liabilities, contingent obligations and commitments in other than the normal course of business and at amounts different from those in the accompanying financial statements.

In our opinion, except for the effects on the 1980 financial statements of such adjustments, if any, as might have been required had we been able to satisfy ourselves as to the reasonableness of the product warranty liability as discussed in the second paragraph, and subject to the effects on the 1980 financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty about the achievement of profitable operations, restructuring of financing arrangements including the ability to obtain additional financing as required, as discussed in the third paragraph, the financial statements referred to above present fairly the consolidated financial position of W.L. Jackson Manufacturing company and subsidiaries at December 31, 1980 and 1979, and the consolidated results of their operations

and changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Ernst & Whinney

Chattanooga, Tennessee
April 7, 1981

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

BRADFORD-WHITE CORPORATION	:	CIVIL ACTION
V.	:	
ERNST & WHINNEY	:	NO. 83-3371

CIVIL JUDGMENT

FILED JULY 30, 1986

Before **HON. JOSEPH L. McGLYNN, JR.**

AND NOW, this 25th day of July 1986 in accordance with the jury's answers to Special Interrogatories and the Court having molded the Verdict therefrom,

IT IS ORDERED that Judgment be and the same is hereby entered in favor of BRADFORD-WHITE CORPORATION, the plaintiff, and against ERNST & WHINNEY, the defendant, in the amount of ONE MILLION, TWO HUNDRED AND FORTY-TWO THOUSAND, ONE HUNDRED AND FIFTY-ONE ($1,242,151.00) DOLLARS.

ENTERED: JULY 30, 1986
CLERK OF COURT

BY THE COURT:
ATTEST:
/s/ BEVERLEE BEARMAN
BEVERLEE BEARMAN
Courtroom Deputy Clerk